Simon Collinson Rajneesh Narula Alan M. Rugman

INTERNATIONAL BUSINESS

Eighth Edition

Pearson

INTERNATIONAL BUSINESS

At Pearson, we have a simple mission: to help people make more of their lives through learning.

We combine innovative learning technology with trusted content and educational expertise to provide engaging and effective learning experiences that serve people wherever and whenever they are learning.

From classroom to boardroom, our curriculum materials, digital learning tools and testing programmes help to educate millions of people worldwide – more than any other private enterprise.

Every day our work helps learning flourish, and wherever learning flourishes, so do people.

To learn more, please visit us at **www.pearson.com/uk**

INTERNATIONAL BUSINESS

Eighth Edition

Simon Collinson
University of Birmingham

Rajneesh Narula
University of Reading

Alan M. Rugman
University of Reading

Pearson

Harlow, England • London • New York • Boston • San Francisco • Toronto • Sydney • Dubai • Singapore • Hong Kong
Tokyo • Seoul • Taipei • New Delhi • Cape Town • São Paulo • Mexico City • Madrid • Amsterdam • Munich • Paris • Milan

PEARSON EDUCATION LIMITED

KAO Two

KAO Park

Harlow CM17 9SR

United Kingdom

Tel: +44 (0)1279 623623

Web: www.pearson.com/uk

First published by McGraw-Hill Inc. 1995

Second edition published by Pearson Education Limited 2000 (print)

Third edition published 2003 (print)

Fourth edition published 2006 (print)

Fifth edition published 2009 (print)

Sixth edition published 2012 (print and electronic)

Seventh edition published 2017 (print and electronic)

Eighth edition published 2020 (print and electronic)

ISBN: 978-1-292-27415-7 (print)
978-1-292-27416-4 (PDF)
978-1-292-27417-1 (ePub)

British Library Cataloguing-in-Publication Data

A catalogue record for the print edition is available from the British Library

Library of Congress Cataloging-in-Publication Data

A catalog record for the print edition is available from the Library of Congress

Names: Collinson, Simon, author. | Narula, Rajneesh, 1963- author. | Qamar, Amir, author. | Rugman, Alan M. International business.

Title: International business / Simon Collinson, University of Birmingham, Rajneesh Narula, Henley Business School, the University of Reading, Amir Qamar, Previously at Henley Business School, the University of Reading.

Description: 8th Edition. | Hoboken : Pearson, 2020. | Revised edition of International business, 2017. | Includes bibliographical references and index. |

Identifiers: LCCN 2019048205 (print) | LCCN 2019048206 (ebook) | ISBN 9781292274157 (paperback) | ISBN 9781292274171 (epub)

Subjects: LCSH: International business enterprises--Management.

Classification: LCC HD62.4 .C6255 2020 (print) | LCC HD62.4 (ebook) | DDC 658/.049--dc23

LC record available at https://lccn.loc.gov/2019048205

LC ebook record available at https://lccn.loc.gov/2019048206

10 9 8 7 6 5 4 3 2 1

24 23 22 21 20

Front cover image: ImageFlow/Shutterstock

Print edition typeset in 10/12.5 Times LT Pro by SPi Gobal

Print edition printed and bound in Slovakia by Neografia

NOTE THAT ANY PAGE CROSS REFERENCES REFER TO THE PRINT EDITION

CONTENTS IN BRIEF

CONTENTS IN DETAIL

Chapter 2
General Frameworks in International Business

Objectives of the chapter

Part Two

THE ENVIRONMENT OF INTERNATIONAL BUSINESS

Chapter 4

International Politics

Chapter 6
International Trade

Chapter 9
Organising Strategy

Chapter 10

Corporate Strategy and National Competitiveness

Chapter 13
Human Resource Management Strategy

Chapter 14
Political Risk and Negotiation Strategy

Chapter 15

International Financial Management

Chapter 18

North America

Chapter 19
Emerging Economies

Chapter 20
China

Supporting resources

Visit **go.pearson.com/uk/he/resources** to find valuable online resources

For instructors

- Instructor's Manual
- PowerPoints

For more information please contact your local Pearson Education sales representative or visit **go.pearson.com/uk/he/resources**

LIST OF FIGURES AND TABLES

Figures

Tables

PREFACE

The eighth edition of *International Business*

We have continued to evolve the structure and content of this textbook in step with the rapidly changing world of international business. This includes completely revising several key chapters, including Chapter 6, on International Trade. This is entirely updated and includes new case studies covering both the trade-war between the US and China and the complex Brexit process. These and other real-world developments have made a wide range of stakeholders much more aware of the significance of global trade interdependencies than in the past. Chapter 16 on the European Union is also entirely updated to take account of Brexit and a range of new socio-political and economic events in Europe.

Chapter 11 ('MNEs as Responsible Stakeholders') has been removed, making this edition more consolidated, with 20 rather than 21 chapters. In place of Chapter 11 we have inserted new sections, frameworks and case studies on responsible business throughout the book as a fundamental dimension of international business theory and practice across all the other chapters. New case studies, such as 'Businesses and NGOs working together on climate change' in Chapter 4, provide additional material on this topic. Chapter 14, on 'Political Risk and Negotiation Strategy' also features new case studies 'From riches to rags: the decline of the Venezuelan oil industry' and 'Huawei accused of spying'.

There are 95 case studies and more new and revised case studies than in the last edition. Of these, 25 are completely new and 70 have been thoroughly updated. The brand-new case studies represent a more diverse set of stories and illustrations, facts and figures, from different industries

and countries, from the fortunes of the Turkish Lira to M-Pesa in Kenya; the significance of tomato exports for Mexico to the Chinese government's international push via the 'Belt and Road Initiative'.

The Introduction outlines a number of guiding frameworks to help the reader navigate, providing an overview of our approach and the structure of the book as well as the standard sections of each chapter. Figure 3 provides an outline, linked to a description of how the book is organised. Within the chapters the structure should be familiar to those who have used the book before. We have kept five case studies in each Chapter (except Chapter 1, which introduces the field of international business). Every Chapter has been thoroughly updated, with new data, trends, and references. A revised bibliography appears at the end of each chapter.

Acknowledgements

Our lead contributor and researcher on this project was Dr Amir Qamar, a Lecturer (Assistant Professor) in Strategic Management in the Department of Strategy and International Business at Birmingham Business School, University of Birmingham (see below). He deserves a big thank you for coordinating the revision process and updating large parts of the book.

Amir provided 17 of the new case studies and helped shape the new emphasis described above. He was lead author on: 'US manufacturing: from China to Mexico' (Chapter 2); 'Worrying times for Singapore's SMEs' (Chapter 2); 'R&D at Hewlett-Packard' (Chapter 3); 'Greece: third (bailout) time lucky' (Chapter 4); 'Businesses and NGOs work together on climate change' (Chapter 4); 'Turkish Lira in crisis: record low in 2018' (Chapter 4); 'Konami is watching its employees' (Chapter 5); 'The collective culture of John Lewis & Partners' (Chapter 5); 'US and China trade-war: battle of the giants' (Chapter 6); 'China's rare earth minerals'

(Chapter 6); ‘Slowdown in China: Global financial markets and contagion effects’ (Chapter 7); ‘Social media: Serengetee’ (Chapter 8); ‘Baker Tilly Changes its name to RSM’ (Chapter 9); ‘The global beer industry: decline and growth at the same time’ (Chapter 10); ‘H&M learning from Zara’ (Chapter 11); ‘Adidas: promoting a global sports brand’ (Chapter 12); ‘The 2018 retail crisis catches up with Marks & Spencer’ (Chapter 12); ‘Primark: putting global stakeholders first’ (Chapter 13); ‘Huawei accused of spying’ (Chapter 14); ‘Intel effect’ (Chapter 14); ‘Financial transparency at Siemens’ (Chapter 15); ‘Carillion’s collapse’ (Chapter 15); ‘Brexit troubles for Jaguar Land Rover’ (Chapter 16); ‘VW diesel dispute’ (Chapter 16); ‘Air Canada’s bid for consolidation’ (Chapter 18); ‘Mexico’s tomatoes’ (Chapter 18); ‘Airbus secures new deal with China’ (Chapter 20); ‘Alibaba steps up to global competition’ (Chapter 20). He is also the author for the Instructor’s Manual and supplementary PowerPoint slides.

Dr Emma C. Gardner, a Lecturer (Assistant Professor) in the Department of Strategy and International Business at Birmingham Business School, University of Birmingham, also provided excellent new case studies for the book. Emma was lead author for: ‘The Big Four’ (Chapter 7); ‘Tesco at home and abroad’ (Chapter 8); ‘The glass ceiling’ (Chapter 13); ‘India’s role in the global offshoring economy’ (Chapter 13); ‘Sony-diversifying into the automobile industry?’ (Chapter 17); ‘China’s One Belt One Road’ (Chapter 20).

Thanks also go to Kieran Collinson for updating large segments of the book, as well as providing three of the new cases in this edition. Kieran was lead author for ‘Magna International Inc.’ (Chapter 11); ‘From riches to rags: the decline of the Venezuelan oil industry’ (Chapter 14); ‘M-Pesa: Kenya’s mobile money service leapfrogging traditional banks’ (Chapter 15). We are also grateful to Dr Roshan (Dev) Boojihawon, a Senior

Lecturer in Strategy at Birmingham Business School, who led on Renewed advantage through vertical integration at Floreal Knitwear’ (Chapter 10) and ‘Mirum – never lose your sense of wonder’ (Chapter 12).

Considerable research support for Rajneesh Narula was provided by Jill Juergensen, doctoral candidate at the Henley Business School, who assisted with the updates in Chapters 1–3. We acknowledge Dr Irina Surdu, lecturer at Henley Business School, University of Reading as the lead author of two cases in Chapter 2: ‘Walmart Inc.’, and ‘Back again? IKEA’s re-entry into Japan’. Dr Karim Kirollos, a Teaching Fellow in International Business at Aston University, helped edit and update the text and cases associated with Rajneesh’s chapters. Additional assistance was provided by Jong Min Lee, lecturer at Henley Business School, University of Reading.

ABOUT THE AUTHORS

Dr Simon Collinson is Deputy Pro-Vice-Chancellor, Director of the City-Region Economic Development Institute (City-REDI) and Professor of International Business and Innovation at the University of Birmingham. He also a Fellow of the Royal Society (FRSA), the Academy of Social Sciences (FAcSS) and the British Academy of Management (FBAM).

Previous roles include Chair of the Chartered Association of Business Schools (CABS) and member of the UK Economic and Social Research Council (ESRC). He was Professor of International Business at Henley Business School, University of Reading and Deputy Dean and Professor of International Business at Warwick Business School, University of Warwick (UK). He was also an Academic Associate at the Centre for International Business and Management (CIBAM), Judge Business School, Cambridge, and a Research Associate at the Centre for Competitive Advantage in the Global Economy (CAGE) at Warwick University. Prior to Warwick he was Lecturer and Senior Research Fellow at Edinburgh University Management School and the Assistant Director of the Japanese–European Technology Studies (JETS) Institute for seven years.

Simon has held visiting positions at Zhejiang University, the Australian Graduate School of Management (AGSM) in Sydney, the Kelley School of Business, Indiana University, Hitotsubashi University and the National Institute of Science and Technology Policy (NISTEP) in Tokyo, and the John Dunning Centre for International Business, Henley Business School, University of Reading. Following a Joint BA (Hons.) in Geography and Sociology at Leeds University and an MA in Human Geography at the

University of Florida, Gainesville, Simon was awarded his D.Phil. from the Science Policy Research Unit (SPRU) at Sussex University in 1991.

His original research was on technology transfer and indigenous technological capabilities in Kenyan manufacturing firms. Since then projects and papers have focused on global innovation strategies, R&D, knowledge and intellectual asset management in multinational firms; the competitiveness of international UK firms; national systems of innovation and emerging economies; high-technology entrepreneurship, small-firm networks and regional development; Japan and China: local business practices and cross-cultural management, foreign direct investment and economic change. Simon has received research funding awards from the UK ESRC and the Engineering and Physical Sciences Research Council (EPSRC), the UK government's Department of Trade and Industry, Japan's Science and Technology Agency, the British Royal Society and European Commission Director General (/Directorate) XII (DGXII) of the European Union.

He has research, consulting and executive teaching experience with a wide range of multinational firms. He has published a range of books, including *From Complexity to Simplicity* which was shortlisted for the Chartered Management Institute (CMI) business book of the year prize. He has also published in refereed journals including *Journal of International Business Studies*, *Organization Studies*, *Business History*, *Research Policy*, *Multinational Business Review*, *International Journal of Technology Management*, *European Management Journal*, *R&D Management*, *Organization Dynamics* and *Technology Analysis & Strategic Management*. His research has also featured in the *Independent*, *The Times*, *The Sunday Times*, BBC Radio 4, the *New Statesman* and the *U.S. News & World Report*.

While continuing to publish on China, innovation and the evolving competitiveness of emerging economies, he has recently focused on innovation and productivity and firms in the context of inclusive regional economic growth at City-REDI.

Dr Rajneesh Narula, OBE is the John H. Dunning Chair of International Business Regulation at the Henley Business School, University of Reading, UK. He has previously held positions at Copenhagen Business School, BI Norwegian Business School, the University of Oslo, and the University of Maastricht. He currently holds honorary appointments at UNU-MERIT, Norwegian Business School, the University of Urbino and Oxford University.

In 2017, he was appointed an Honorary Officer of the Most Excellent Order of the British Empire (OBE). The honour is in recognition of his Services to Business Research. He was elected a Fellow of the Royal Society of Arts, Manufactures and Commerce (FRSA) in 2015. He is a regular commentator on business and economics issues on BBC World News, CGTN, TRT World, as well as a variety of print and online publications, and gives over 30 public lectures and seminars at universities around the world every year.

His research and consulting have focused on the role of multinational firms in development, innovation and industrial policy, R&D alliances and outsourcing. He has published over a hundred articles and chapters in books on these themes. He was Editor-in-Chief of *Multinational Business Review* from 2014 to 2016, and is currently Area Editor for the *Journal of International Business Studies* (2016–22). He was Editor-in-Chief of *The European Journal of Development Research* from 2009 to 2013.

He regularly acts as a consultant and advisor to the European Commission, United Nations Industrial Development Organization

(UNIDO), United Nations Conference on Trade and Development (UNCTAD), the Organization for Economic Co-operation and Development (OECD), and a variety of other international and national organisations. He has travelled widely, having undertaken research and consultancy projects or taught in Tanzania, Uganda, Thailand, China, Vietnam, Russia, India, Qatar, UAE, Colombia, Australia, Japan, Mauritius, Senegal and Pakistan, Bangladesh, South Africa, in addition to almost all the countries of the EU.

He is listed as one of the top 20 most cited academic authors worldwide in the fields of international business, emerging markets, economics of innovation and economic development. His publications with John Dunning and Sanjaya Lall on FDI-assisted development are especially well-cited contributions on the subject.

He is the author or editor of 13 books, including *Globalization & Technology* (Polity Press, 2003), *Multinationals and Industrial Competitiveness* (with John Dunning, Edward Elgar, 2004), *Understanding FDI-assisted Economic Development* (with Sanjaya Lall, Routledge, 2004), and *Multinationals on the Periphery* (with Gabriel Benito, Palgrave, 2007). His publications have appeared in leading journals, including the *Journal of International Business Studies*, *Oxford Development Studies*, *Research Policy*, *Journal of Management Studies*, *Journal of World Business*, and *Management International Review*. His 2003 book *Globalization and Technology* has been translated and published in Chinese and Arabic.

He obtained his B.Eng. (Electrical Engineering, with Hons.) from Ahmadu Bello University, Zaria Nigeria, an MBA from Rutgers University and his Doctorate in International Business and Economics from Rutgers University, US. Before academia, Professor Narula worked as an Engineer in Nigeria, and later as a Planning Analyst at IBM Asia/Pacific Headquarters in Hong Kong.

Dr Alan M. Rugman was, until his untimely death in July 2014, the lead author of this book and Professor of International Business at the Henley Business School and Head of School, International Business and Strategy at the University of Reading, UK. He held visiting positions at Columbia Business School, London Business School, Harvard University, UCLA, MIT, Warwick Business School, the University of Paris–La Sorbonne, University of Sydney, Saint Louis University, and the University of Lyon. Dr Rugman published over 300 articles dealing with the economic, managerial and strategic aspects of multinational enterprises and with trade and investment policy. He is recognised as one of the ten most-cited scholars in the field of international business worldwide.

As a leading authority in international business, Dr Rugman served as President of the Academy of International Business from 2004 to 2006, was elected a Fellow of the Academy in 1991, and served as Dean of the Fellows. He was also a Fellow of the Royal Society of Arts, elected 1998. He served on the Editorial Board of the *Journal of International Business Studies* and was the Editor-in-Chief of the *Multinational Business Review*.

Dr Amir Qamar is a Lecturer (Assistant Professor) in Strategic Management in the Department of Strategy and International Business at Birmingham Business School, University of Birmingham. Amir has a background in Economics and International Business, but his more recent work has focused on Operations Management and Supply Chain Management as his PhD research investigated the performance and contextual trade-offs between lean and agile organisations within the automotive industry.

After completing a PhD in Management at Birmingham Business School, Amir joined the City-Region Economic Development Institute (City-REDI) at the University of Birmingham, where he worked on a range

of projects including low-pay and productivity. As an External Associate, Amir is still closely working with City-REDI to better-understand the relationships between the regional economy and specific firms.

Amir’s published papers appear in journals such as *Supply Chain Management: An International Journal* and the *International Journal of Production Research.* Amir has edited several books and has also worked on the seventh edition of the Collinson, Narula and Rugman *International Business* textbook. His research interests include investigating multiplier effects within certain supply chains, the employment footprint of MNEs, ambidextrous production processes, R&D initiatives, productivity levels and research methods. Amir is also an Officer of the Academy of International Business (AIB) Research Methods Shared Interest Group and the lead organiser of the Annual Strategy and International Business Symposium (ASIBS) at the Birmingham Business School. Amir has experience of teaching a wide range of modules in the domains of business strategy and operations.

GUIDE TO THE CASE STUDIES

CHAPTER	TYPE OF CASE	ORGANISATION/INDUSTRY	COUNTRY/ REGION	NEW/ REVISED	PAGE
Chapter 1 (n/a) An Introduction to International Business					
Chapter 2 General Frameworks in International Business	Active Learning Case	Starbucks: a global 'coffee culture'	US	Revised	61
	International Business Strategy in Action	US manufacturing: from China to Mexico	US/Emerging Economies: China/Mexico	Revised	69
	International Business Strategy in Action	Worrying times for Singapore's SMEs	Singapore	Revised	76
	Real Case	Walmart Inc.	US	New	81
	Real Case	Back again? IKEA's re-entry into Japan	Japan	New	83
Chapter 3 Multinational Enterprises, Innovation and Competitiveness	Active Learning Case	GE Healthcare in India: locally driven innovation	US/Asia	Revised	89
	International Business Strategy in Action	Spreadshirt: open innovation	EU	Revised	105
	International Business Strategy in Action	Innovation networks at IBM	US	Revised	113
	Real Case	Canon Group	Japan	Revised	116
	Real Case	R&D at Hewlett-Packard	US	Revised	118
Chapter 4 International Politics	Active Learning Case	How risky is foreign investment in Russia?	Emerging Economies	Revised	124
	International Business Strategy in Action	Greece: third (bailout) time lucky	Greece	Revised	130
	International Business Strategy in Action	Businesses and NGOs work together on climate change	Europe	New	136
	Real Case	How environmental regulations can be used as trade barriers	US/Emerging Economies	Revised	143
	Real Case	Turkish lira in crisis: record low in 2018	Turkey	New	144
Chapter 5 International Culture	Active Learning Case	Cultures clash as big pharma gets bigger	EU: Sweden and Italy/US	Revised	148
	International Business Strategy in Action	McDonald's	US	Revised	153
	International Business Strategy in Action	The collective culture of John Lewis & Partners	UK	Revised	168
	Real Case	Konami is watching its employees	Japan	New	173
	Real Case	Sport can be local and global: Manchester United	EU/US/Asia	Revised	174
Chapter 6 International Trade	Active Learning Case	US–China trade war: battle of the giants	US and China	New	180
	International Business Strategy in Action	Microsoft shows the world is not flat	US/EU	Revised	188
	International Business Strategy in Action	Brexit: A sharp lesson in the importance of trade interdependencies	Europe	New	193
	Real Case	China's Rare Earth Minerals	China	New	202
	Real Case	Dumping on trade complaints	Canada/US	Revised	203
Chapter 7 International Financial Markets and Institutions	Active Learning Case	Barclays Bank international financial dealings	EU: UK	Revised	214
	International Business Strategy in Action	The Big Four	UK	Revised	228
	International Business Strategy in Action	AngloGold Ashanti	Emerging Economies: South Africa	Revised	236
	Real Case	HSBC	EU: UK	Revised	240
	Real Case	Slowdown in China: Global financial markets and contagion effects		Revised	241
Chapter 8 Multinational Strategy	Active Learning Case	Vodafone and the triad telecom market	EU	Revised	252
	International Business Strategy in Action	Tesco at home and abroad	US/Japan/UK	Revised	256
	International Business Strategy in Action	Fuji Xerox and Xerox	US/Japan	Revised	266
	Real Case	3M	US	Revised	273
	Real Case	Social media: Serengetee	Global	New	274
Chapter 9 Organising Strategy	Active Learning Case	Procter & Gamble	US	Revised	283
	International Business Strategy in Action	Sanofi-Aventis	EU: France/ Germany	Revised	287
	International Business Strategy in Action	Baker Tilly changes its name to RSM	UK	New	294
	Real Case	LVMH: organising luxury products in the international arena	EU: France	Revised	303
	Real Case	Maersk Group	EU: Denmark/ US/Asia	Revised	304
Chapter 10 Corporate Strategy and National Competitiveness	Active Learning Case	Worldwide operations and local strategies of ABB	EU	Revised	310
	International Business Strategy in Action	Nokia and Ericsson: moving beyond mobiles	EU	Revised	318
	International Business Strategy in Action	Renewed advantage through vertical integration at Floreal Knitwear	Asia	Revised	323
	Real Case	The global beer industry: decline and growth at the same time?	Global	New	327
	Real Case	IBM	US/EU	Revised	329
Chapter 11 Production Strategy	Active Learning Case	GE production: from Six Sigma to the GE Store	US	Revised	336
	International Business Strategy in Action	H&M Learning from Zara	Europe	New	343
	International Business Strategy in Action	Magna International Inc.	Canada	New	344
	Real Case	Flextronics	Emerging Economies: Singapore	Revised	360
	Real Case	Nike	US	Revised	362
Chapter 12 Marketing Strategy	Active Learning Case	Adidas: promoting a global sports brand	UK/Brazil	Revised	366
	International Business Strategy in Action	Weeby buys Tappy	US/Emerging Economies: Vietnam	Revised	375
	International Business Strategy in Action	The 2018 retail crisis catches up with Marks & Spencer	UK	New	377
	Real Case	Bang & Olufsen	EU: Denmark/ US	Revised	390
	Real Case	Mirum – never lose your sense of wonder!	US	Revised	392
Chapter 13 Human Resource Management Strategy	Active Learning Case	The Coca-Cola Company thinks local	US	Revised	397
	International Business Strategy in Action	The glass ceiling	UK	Revised	404
	International Business Strategy in Action	Primark: putting global stakeholders first	UK	Revised	411
	Real Case	India's role in the global offshoring economy	India	New	419
	Real Case	Executive search firms	EU	Revised	420
Chapter 14 Political Risk and Negotiation Strategy	Active Learning Case	Nestlé in Nigeria	Emerging Economies: Nigeria	Revised	425
	International Business Strategy in Action	From riches to rags: the decline of the Venezuelan oil industry	Venezuela	New	441
	International Business Strategy in Action	Intel effect	Emerging Economies: Costa Rica	Revised	442
	Real Case	Huawei accused of spying	China	New	453
	Real Case	Problems with ports	Japan/ Emerging Economies: Kenya	Revised	454
Chapter 15 International Financial Management	Active Learning Case	Financial transparency at Siemens	EU: UK/US	Revised	460
	International Business Strategy in Action	Worldwide tax havens	Emerging Economies	Revised	470
	International Business Strategy in Action	Sovereign wealth funds	Middle East/ US/EU	Revised	473
	Real Case	Carillion's collapse	UK	New	489
	Real Case	M-Pesa: Kenya's mobile money service leapfrogging traditional banks	Kenya	New	490
Chapter 16 European Union	Active Learning Case	Brexit troubles for Jaguar Land Rover	UK and Europe	New	498
	International Business Strategy in Action	VW diesel dispute	US/EU	Revised	509
	International Business Strategy in Action	The future is Orange	EU: France	Revised	513
	Real Case	Accor budget hotels	EU: France	Revised	522
	Real Case	Carrefour	EU: France	Revised	523
Chapter 17 Japan	Active Learning Case	Doing business in Japan	Japan	Revised	528
	International Business Strategy in Action	Kirin Beer goes international	Japan	Revised	542
	International Business Strategy in Action	Walmart takes Seiyu	US/ Japan	Revised	549
	Real Case	Renault, Nissan and Mitsubishi Alliance: no pain, no gain	Japan/EU: France	Revised	555
	Real Case	Sony – diversifying into the automobile industry?	Japan	Revised	558
Chapter 18 North America	Active Learning Case	FTA, NAFTA and CUSMA	US/Emerging Economies: Mexico and Canada	Revised	563
	International Business Strategy in Action	Air Canada's bid for consolidation	Canada	New	568
	International Business Strategy in Action	Mexico's tomatoes	Mexico and US	New	578
	Real Case	Jumex of Mexico	Emerging Economies: Mexico	Revised	584
	Real Case	GlaxoSmithKline in the United States	UK/US	Revised	585
Chapter 19 Emerging Economies	Active Learning Case	Acer Taiwan goes international	Emerging Economies: Taiwan	Revised	589
	International Business Strategy in Action	From Oserian to Tesco: the Kenyan cut flower industry	Emerging Economies: Kenya	Revised	600
	International Business Strategy in Action	Korean chaebols: Hyundai and Samsung	Emerging Economies: S. Korea	Revised	609
	Real Case	The Indian IT, software and services industry	Emerging Economies: India	Revised	612
	Real Case	Bumrungrad International in Thailand	Emerging Economies: Thailand	Revised	614
Chapter 20 China	Active Learning Case	Oxford Instruments in China	EU: UK/ Emerging Economies: China	Revised	621
	International Business Strategy in Action	Airbus secures a deal with China	China: France	New	628
	International Business Strategy in Action	Alibaba steps up to global competition	China	New	639
	Real Case	China's One Belt One Road	China	New	642
	Real Case	Nanjing Auto makes the MG	EU: UK/ Emerging Economies: China	Revised	644

PUBLISHER'S ACKNOWLEDGEMENTS

Photo Credit(s):

1 GETTY IMAGES INCORPORATED: eternalcreative/iStock /Getty Images Plus/Getty Images; **41 SHUTTERSTOCK:** wavebreakmedia/Shutterstock; **126 Alamy Images:** Quentin Bargate/Alamy Stock Photo; **303 Alamy Images:** FORGET Patrick/SAGAPHOTO.COM/Alamy Stock Photo; **305 Alamy Images:** Peter Titmuss/Alamy Stock Photo; **174 Alamy Images:** Russell Hart/Alamy Stock Photo; **236 Alamy Images:** Joerg Boethling/Alamy Stock Photo; **252 Alamy Images:** ScottyH/Alamy Stock Photo; **274 Serengetee:** Used with permission of Serengetee, Men-Women Mission; **287 GETTY IMAGES INCORPORATED:** THOMAS WIRTH/Stringer/AFP/Getty Images; **330 GETTY IMAGES INCORPORATED:** Iain Masterton/arabianEye/Getty Images; **361 Alamy Images:** Ingemar Magnusson/Alamy Stock Photo; **391 GETTY IMAGES INCORPORATED:** Francis Joseph Dean/Deanpictures/Corbis/Getty Images; **455 Alamy Images:** age fotostock/Alamy Stock Photo; **471 Alamy Images:** Trevor Smith/Alamy Stock Photo; **474 Alamy Images:** Iain Masterton/Alamy Stock Photo; **514 GETTY IMAGES INCORPORATED:** Ulrich Baumgarten/Getty Images; **524 Alamy Images:** Craig Joiner Photography/Alamy Stock Photo; **528 Alamy Images:** Iain Masterton/Alamy Stock Photo; **542 Alamy Images:** Trevor Mogg/Alamy Stock Photo; **559 Alamy Images:** Yaacov Dagan/Alamy Stock Photo; **563 GETTY IMAGES INCORPORATED:** Bettmann/Getty Images; **609 Alamy Images:** EPA/BARBARA WALTON/epa european

pressphoto agency b.v./Alamy Stock Photo; **616 SHUTTERSTOCK:** Apples Eyes Studio/Shutterstock; **645 GETTY IMAGES INCORPORATED:** Matthew Lewis/Stringer; **645 Alamy Images:** David Lyons/Alamy Stock Photo.

Text Credit(s):
xxxii Kurt Lewin: Quote by Kurt Lewin (1890–1947); **6 JOHN WILEY AND SONS INCORPORATED**: R. Narula, *Globalization and Technology: Interdependence, Innovation Systems and Industrial Policy (* Cambridge: Polity Press, 2003); **14 Taylor & Francis**: B. Gregersen and B. Johnson, 'Learning economies, innovation systems and European integration', *Regional Studies*, vol. 31, no. 5 (1997), pp. 479–90; **15 Rajneesh Narula**: Adapted from R. Narula and G. D. Santangelo, 'Location and collocation advantages in international innovation', *Multinational Business Review*, vol. 20, no.1 (2012), pp.6–25; **16 Stanford University Press**: D. Held, *Global Transformations: Politics, Economics and Culture* (Stanford, CA: Stanford University Press, 2007); **17 Springer:** J. H. Dunning, 'The eclectic paradigm of international production: a restatement and some possible extensions', *Journal of International Business Studies* (1988), pp. 1–31; **23–25 Pearson Education:** Adapted from J. H. Dunning, *Multinational Enterprises and the Global Economy* (Wokingham: Addison Wesley, 1993); **29–30 United Nations Conference on Trade and Development:** Created by the author based on data taken from UNCTAD (1980–2017); **31 United Nations Conference on Trade and Development:** Created by author, data taken from UNCTADSTAT; **32 United Nations Conference on Trade and Development:** Adapted from UNCTAD. *World Investment Report*, 2018, Table 1.7 (p. 29); **49 TACNA Services:** TACNA Services, Mexico vs. China Manufacturing. Retrieved from http://tacna.net/mexico-vs-china/ **49, 50 FINANCIAL TIMES**

LIMITED: James Kynge (2015), Mexico steals a march on China in car manufacturing, April 21 © Financial Times Limited 2019. All rights reserved; **53 Google: Google search, Our Approach to Search, Our mission. Retrieved from** https://www.google.com/search/howsearchworks/mission/; **53 Save the Children: NGO, Save the Children**; **57 Rajneesh Narula: A. Cuervo-Cazurra, and R. Narula, 'A set of motives to unite them all? Revisiting the principles and typology of internationalization motives',** *Multinational Business Review*, vol. 23, no 1 (2015). Reprinted with permission from Rajneesh Narula; **64 Springer: Shawna O'Grady and Henry W. Lane, 'The psychic distance paradox',** *Journal of International Business Studies*, vol. 27, no. 2 (1996), pp. 309–33; **65 Harvard Business Publishing: Created by author and adapted from** Ghemawat, Pankaj. 'Distance still matters: the hard reality of global expansion', *Harvard Business Review*, vol. 79, no. 8 (September 2001); **71 Springer Nature: P. J. Buckley and M. C. Casson, 'The internalisation theory of the multinational enterprise: a review of the progress of a research agenda after 30 years',** *Journal of International Business Studies*, vol. 40, no. 9 (2009), pp. 1563–80; **72 Elsevier:** Authors adapted from Buckley, Peter J., 'The impact of the global factory on economic development', Journal of World Business, vol. 44, no. 2 (2009), pp. 131–43; **76 Springer:** SBF-DP SME Index St. Graphics; **77 Springer: J. A. Mathews and** I. Zander, 'The international entrepreneurial dynamics of accelerated internationalization', *Journal of International Business Studies*, vol. 38, no. 3 (2007), pp. 387–403; **78–79 John Houlden:** S. Collinson and J Houlden, 'Decision-making and market orientation in the internationalization process of small and medium-sized enterprises'. Warwick Business School Working Paper (2005) Reprinted with permission from John Houlden; **79–80 Taylor &**

Francis: S. C. Collinson, *Small and Successful in Japan: A Study of 30 British Firms in the World's Most Competitive Market* (London: Avebury Press/Ashgate Publishing Group, 1996); **90 Publications Office of the European Union:** Although slightly dated, this definition is still one of the best. European Commission, "Green Paper on Innovation," *Bulletin of the European Union, Supplement 5/95 (Brussels: European Commission*, 1995, p. 1); **92–93 UNESCO Institute for Statistics:** Author's creation based on data extracted from the UNESCO Institute for Statistics (UIS); **93–94 U.S. Patent and Trademark Office:** Author's creation using data from the Patent Technology Monitoring Team Report issued by the USPTO (December 2015); **96 Bloomberg L.P:** Author's creation based on data from Bloomberg, company reports; **98–100 Academy of Management:** J. B. Barney, 'Looking inside for competitive advantage', *Academy of Management Executive*, vol. 9, no. 4 (1995), pp. 49–61; **101 FINANCIAL TIMES LIMITED:** Campbell, P, and Waters, R. 2018. 'Tesla seeks to convince it has turned the corner', *Financial Times*, August 2 © Financial Times Limited 2019. All rights reserved. Available at: https://www.ft.com/content/ea70d7f8-9644-11e8-b747-fb1e803ee64e (last accessed: 27 November 2018) © 2019 The Financial times. All rights reserved; **106 Elsevier:** Soete, L., Verspagen, B., & Weel, B. ter. (2011, June 28). Systems of Innovation. Retrieved from http://www.sciencedirect.com/science/article/pii/S0169721810020113; **107 Pinter Publishers:** C. Edquist and B. Johnson, 'Institutions and organizations in systems of innovation', in C. Edquist (ed.), *Systems of Innovation: Technologies, Institutions and Organizations* (London: Pinter Publishers/Cassel Academic, 1997, p. 46); **111 Harvard Business Publishing:** Adapted from C. Bartlett and S. Ghoshal, *Managing across Borders: The Transnational Solution* (Boston, MA: Harvard Business

School Press, 2002); **111 JOHN WILEY AND SONS INCORPORATED:** Adapted from N. Nohria and S. Ghoshal, *The Differentiated Network: Organizing MNCs for Value Creation* (San Francisco, CA: Jossey-Bass, 1997); **113 Ginni Rometty**: Ginni Rometty, IBM’s chairman, president, and CEO; **113 U.S. Patent and Trademark Office:** 2017 Top 25 USPTO Recipients, United States Patent Office; **113 Quote by Sam Palmisano 114 IBM:** Adapted from IBM’s research labs. Retrieved from http://www.research.ibm.com/worldwide/index.shtml; **115 SAGE Publications:** S. Raisch and J. M. Birkinshaw, ‘Organizational ambidexterity: antecedents, outcomes, and moderators’, *Journal of Management*, vol. 34, no. 3 (2008), pp. 375–409; **118 Quote by Fujio-Mitarai’s 130 Springer:** R. Molz, ‘Privatization of government enterprise: the challenge to management’, *Management International Review*, vol. 29, no. 4 (1989), pp. 29–30; **136 Eurodad:** European network on debt and development, Eurodad 2019; **144 TradingView Inc.:** USDTRY Forex Chart, Trading View. Retrieved from https://uk.tradingview.com/symbols/USDTRY/; **148 Mark H. Corrigan:** American Mark H. Corrigan, Pharmacia and Upjohn Vice President for Clinical Development; **148 Art Atkinson:** Art Atkinson, former Vice President for Clinical Development; **150 McGraw-Hill Education:** D. A. Ball and W. H. McCulloch, *International Business: The Challenge of Global Competition*, 7th ed. (Boston, MA: Irwin McGraw-Hill, 1999), p. 258; **150 SAGE Publications:** G. Hofstede, *Culture’s Consequences: International Differences in Work Related Values* (Beverly Hills, CA: Sage, 1980); **156 Geert Hofstede B.V.:** G. Hofstede, ‘The cultural relativity of organizational practices and theories’, *Journal of International Business Studies* (fall 1983), p. 92. Copyright © Geert Hofstede; **161, 170 Penguin Random House:** Adapted from C. Hampden-Turner and F. Trompenaars,

The Seven Cultures of Capitalism: Value Systems for Creating Wealth in the United States, Britain, Japan, Germany, France, Sweden and the Netherlands (New York: Doubleday, 1993); **162 Springer:** Adapted from Itzhak Harpaz, 'The importance of work goals: an international perspective', *Journal of International Business Studies*, vol. 21, no. 1 (1990), p. 81; **166 McGraw-Hill Education:** Perlmutter in C. A. Bartlett and S. Ghoshal, *Text, Cases and Readings in Cross-Border Management*, 3rd ed. (Boston, MA: McGraw-Hill International Editions, 2000), p. 77; **180** Donald Trump: Trump's threats against China started to gain momentum during his political campaign in 2016; **187, 193 Pearson Education:** Raymond Vernon and Louis T. Wells, Jr., *The Manager in the International Economy* (Englewood Cliffs, NJ: Prentice Hall, 1991), p. 85; **189 Microsoft Corporation:** Microsoft Annual Report 2018; **192 Organization of the Petroleum Exporting Countries:** Adapted from Annual Statistical Bulletin 2017, OPEC. Retrieved from https://www.opec.org/opec_web/static_files_project/media/downloads/publications/ASB2017_13062017.pdf; **199 Bureau of Economist Analysis:** The US current account balance and its components, 2007–15, https://www.bea.gov/news/2019/us-international-transactions-first-quarter-2019-and-annual-update; **202 Statista, Inc.:** Projected rare earth production for China and the rest of world from 2013 to 2018, Statista.com. Retrieved from https://www.statista.com/statistics/279953/rare-earth-production-in-china-and-outside/; **213 Federal Reserve Bank of St. Louis:** Table 1.2. U.S. International Transactions, Expanded Detail:Annual. Retrieved 2018, from https://fred.stlouisfed.org/release/tables?rid=49&eid=4.; **214 U.S. International Trade Commission:** US merchandise trade balance, by major industry/commodity sectors, 2013–17 https://www.usitc.gov/research_and_analysis/trade_shifts_2017/us.htm;

216–217 Barclays: Barclays PLC Annual Report 2017 "Positioned for growth, sharing and success". Retrieved from https://home.barclays/content/dam/home-barclays/documents/investor-relations/reports-and-events/annual-reports/2017/Barclays-Country-Snapshot-2017-final.pdf.; **220 Federal Reserve Bank of St. Louis:** Adapted from K. Alec Chrystal, *St. Louis Fed Review* (March 1984), figure 1, p. 8; **221 FINANCIAL TIMES LIMITED:** UK Pound Sterling/Euro FX Cross Rate, October 29, 2015. © Financial Times Limited, All rights reserved. Retrieved from https://markets.ft.com/data/currencies/tearsheet/summary?s=GBPEUR; **223 Chicago Mercantile Exchange:** Adapted from Chicago Mercantile Exchange. Retrieved from https://www.cmegroup.com/education/fx-monthly-futures-contract-specifications.html; **234 Macrotrends LLC:** LIBOR Rates - 30 Year Historical Chart, Macrotrends. Retrieved from https://www.macrotrends.net/1433/historical-libor-rates-chart; **236 AngloGold Ashanti:** AngloGold, *Annual Report*, 2009, 2014 and 2018; **237 "Brent Crude Oil: Latest Price and Chart."** Hargreaves Lansdown, https://www.hl.co.uk/shares/trading-commodities/brent-crude-oil; **242 Google:** SSE Composite Index, Stock Market, Google Inc. Retrieved from https://www.google.com/search?q=Shanghai+Composite+Index&rlz=1C1GCEA_enGB807GB807&oq=Shanghai+Composite+Index&aqs=chrome..69i57.2j0j7&sourceid=chrome&ie=UTF-8; **242 Google:** Japan's TOPIX Index, Japan Exchange Group, Google Inc. Retrieved from https://www.google.com/search?rlz=1C1GCEA_enGB807GB807&ei=T2a4XIj3K-HGxg-PIoLmgDQ&q=Japan%E2%80%99s+TOPIX+Index&oq=Japan%E2%80%99s+TOPIX+Index&gs_l=psy-ab.3..0i71l8.0.0..29928...0.0..0.0.0.......0......gws-wiz.utC9l1iJIT4; **243**

Google: Hang Seng Index, Google Inc. Retrieved from https://www.google.com/search?rlz=1C1GCEA_enGB807GB807&ei=T2a4XIj3K-HGxgPIoLmgDQ&q=Hong+Kong%E2%80%99s+Hang+Seng+Index&oq=Hong+Kong%E2%80%99s+Hang+Seng+Index&gs_l=psy-ab.3..0j0i22i30l9.21517.22510..22573...0.0..0.50.50.1......0....1j2..gws-wiz.....0..0i71.yChiHTNAvCg; **243 Google:** Taiwan Capitalization Weighted Stock Index, Google Inc. Retrieved from https://www.google.com/search?rlz=1C1GCEA_enGB807GB807&ei=pWa4XL77Mt2H1fAP9tyCmAo&q=TAIEX+Index&oq=TAIEX+Index&gs_l=psy-ab.3..0i67j0i7i30l2j0l3j0i30l4.1671.1671..1951...0.0..0.53.53.1......0....1..gws-wiz.......0i71.vMtErMaNdCQ; **243 Hargreaves Lansdown:** Brent Crude Oil: Latest Price and Chart, Hargreaves Lansdown. Retrieved from https://www.hl.co.uk/shares/trading-commodities/brent-crude-oil; **244 Insider Inc.:** Copper Price Commodity, Markets Insider 2019. Retrieved from https://markets.businessinsider.com/commodities/copper-price; **255-Elsevier:** Adapted from ‘Strategic Planning for a Global Business’, *Columbia Journal of World Business*, summer 1985. Copyright © Elsevier Science & Technology Journals. With permission from Elsevier Science; **259, 263 Michael E. Porter:** Adapted from The Free Press, an imprint of Simon & Schuster Adult Publishing Group, from *Competitive Advantage: Creating and Sustaining Superior Performance* by Michael E. Porter; **261 Pearson Education:** Scott Beardsley and Kinji Sakagami, “Advanced micro devices: poised for chip greatness,” unpublished student paper, Sloan School of Management, MIT, 1988. Reported in Arnoldo C. Hax and Nicolas S. Majluf, *The Strategy Concept and Process: A Pragmatic*

Approach (Englewood Cliffs, NJ: Prentice Hall, 1991), p. 46; **265 Cengage Learning:** Adapted from *International Dimensions of Management*, 2nd ed., by A. Phatak © 1989 South-Western, a part of Cengage. Reprinted by permission www.cengage.com/permissions/; **283 Procter & Gamble:** Structure & Governance, Corporate Structure, Procter & Gamble 2019. Retrieved from http://us.pg.com/who_we_are/structure_governance/corporate_structure; **300 JOHN WILEY AND SONS INCORPORATED:** Adapted from Simcha Ronen, Comparative and Multinational Management, 1986 John Wiley & Sons, Inc.; **303 LVMH:** Record results for LVMH in 2018, January 29, 2019. Retrieved from https://www.lvmh.com/news-documents/press-releases/record-results-for-lvmh-in-2018/; **306 Soren Skou:** Mr. Søren Skou, the Partner Chief Executive Officer of Maersk Line Business; **312–314 Simon & Schuster:** Adapted from The Free Press, an imprint of Simon & Schuster Adult Publishing Group, from The Competitive Advantage of Nations by Michael E. Porter; **313** Michael E. Porter, The Competitive Advantage of Nations (New York: Free Press, 1990), p. 33; **316 Diane Publishing Company:** Adapted from Alan M. Rugman and Joseph R. D'Cruz, *Fast Forward: Improving Canada's International Competitiveness* (Diane Publishing Co., 1991), p. 35; **316 Springer:** Adapted from Alan M. Rugman and Joseph R. D'Cruz, 'The "Double Diamond" Model of International Competitiveness: the Canadian Experience', *Management International Review*, vol. 33, Special Issue 2 (1993), p. 32; **327 Visual Capitalist:** Nick Routley, Mapping the Price of Beer Around the World, Visual Capitalist, June 8, 2018. Retrieved from https://www.visualcapitalist.com/mapping-price-of-beer-around-world/; **328 Brewers Association:** Bart Watson, Premiumization, Prices, and Positioning, Economist, December 6, 2016

https://www.brewersassociation.org/insights/premiumization-prices-and-positioning/; **329 JPMorgan Chase & Co:** What's on tap for the global beer market? The beer industry: Pouring both pints and profits away from the sector August 14, 2018. Retrieved from https://www.jpmorgan.com/global/research/beer-market. Reprinted with permission from JPMorgan Chase & Co.; **341 Academy of Management:** *Academy of Management Executive*, 'The New Competitors: They Think in Terms of 'Speed-to-Market', by Joseph T. Vesey © 1991 The Academy of Management (NY); **343 Simon & Schuster:** Michael E. Porter, *The Competitive Advantage of Nations*, (New York: Free Press, 1990) p. 103; **344 H&M Group:** H&M Annual Report, 2017; **344 BBC** The Journey of a single Zara dress from 'Has this dress been to more countries than you?' By Katie Hope, Business reporter, BBC News 22 March 2017; **347–348 Magna International Inc.:** Magna International: Announces 2019 Annual Meeting Results: MarketScreener. MarketScreener (May 13, 2019') Retrieved from https://www.marketscreener.com/MAGNA-INTERNATIONAL-INC-1410786/news/Magna-International-Announces-2019-Annual-Meeting-Results-28587250/; **355 Harvard Business Publishing:** Joan Magretta, 'Fast, global, and entrepreneurial: supply chain management, Hong Kong style: an interview with Victor Fung', *Harvard Business Review*, (September/October 1998) pp. 105–6; **357 United Nations Conference on Trade and Development:** Adapted from UNCTAD, *World Investment Report*, 2002; **367 Adidas** 2012 Olympic marketing campaign case study, WeThrive, https://wethriveindia.wordpress.com/tag/adidas-marketing-strategy/; **375 Michael Carter:** Quoted by Weeby.co's CEO, Michael Carter; **375 Nguyen Quan:** Vietnam's Minister of Science and Technology, Nguyen Quan; **398 Elsevier:** Adapted from *Colombia Journal of World Business*, Summer

1973, Lawrence G. Franco, "Who manages multinational enterprises?" p. 33, Elsevier Science; **405 The Economist Newspaper Limited:** The Glass-ceiling index, 2017. Used with permission from *The Economist*; **408 Employment Conditions Abroad:** MyExpatriate Market Pay Survey, "Expatriate pay packages in Taiwan cost companies less than most rival locations in Asia Pacific", Employment Conditions Abroad Limited, May 17, 2017. Reprinted with permission; **409 Bloomberg L.P:** Lynsey Chutel, South African CEOs earn over 500 times more than the average worker, Bloomberg, November 19, 2016; **410 International Labour Organization:** International Labour Organization,(2019) ILOSTAT; **416 UBS:** "Global Cities Ranking 2018: UBS Prices and Earnings." Global Cities Ranking 2018 | UBS Prices and Earnings, https://www.ubs.com/microsites/prices-earnings/en/explore/?split=false; **421 Top Executive Search Firms:** About-Top Executive Search firms. Retrieved from http://www.topexecutivesearchfirms.com/about/; **428 McManus, Mark, et al.** "Chinese Word For Crisis = Danger Opportunity. Look . . ." HappyHack, 21 Jan. 2016, http://happyhack.com/chinese-word-crisis-are-opportunity/ **429 United Nations Conference on Trade and Development:** UNCTAD, Investment Policy Monitor database; **434 World Bank Group:** Ease of Doing Business rankings, The World Bank Group (2018). Retrieved from http://www.doingbusiness.org/ranking; **443 Central Bank of Costa Rica:** Central Bank of Costa Rica, Customs, Export Promotion (PROCOMER), p. 13. Reprinted with permission; **446 Springer:** Adapted from John L. Graham, 'The influence of culture on the process of business negotiations: an exploratory study', *Journal of International Business Studies* (spring 1985), p. 88, Palgrave Macmillan; **453 BBC:** Adapted from Lucy Hooker & Daniele Palumbo, (2019) Huawei: The rapid growth of a Chinese champion in five charts', BBC, 20 May; **461**

Joe Kaeser: Siemens Chief Financial Officer, Joe Kaeser; **468 Tax Justice Network:** Tax Justice Network (2018) Financial Secrecy Index. Reprinted with permission from www.financialsecrecyindex.com; **474 Sovereign Wealth Fund Institute:** Top 86 Largest Sovereign Wealth Fund Rankings by Total Assets, 2019. Reprinted with permission from Sovereign Wealth Institute; **489 Carillion PLC:** Making tomorrow a better place, Annual Report and Accounts, Carillion 2016; **491 Cable News Network:** Adapted from The Kieron Monks, (2017) M-Pesa: Kenya's mobile money success story turns 10. Reprinted with permission from Cable News Network; **492 The Brookings Institution:** Used with permission from Robin J. Lewis, John D. Villasenor and Darell M. West, The 2017 Brookings Financial and digital inclusion project report, Building a Secure and Inclusive, Global Financial Ecosystem, August 2017; **498–499 SMMT:** Used with permission from SMMT, Motor Industry facts, June 2018 https://www.smmt.co.uk/wp-content/uploads/sites/2/SMMT-Motor-Industry-Facts-June-2018.pdf; **500 FINANCIAL TIMES LIMITED:** Peter Campbell and Michael Pooler, Brexit triggers a great car parts race for UK auto industry, July 30, 2017 © Financial Times Limited 2019. All rights reserved; **503 European Union:** Surface area in thousands of square Kilometers, Eurostat, European Union; **506 The Conference Board Inc.:** Adapted from International Comparisons of Hourly Compensation Costs in Manufacturing, 2016 – Summary Charts, The Conference Board; **507 Statista, Inc.:** Adapted from McCarthy, Niall, and Felix Richter. "Infographic: Where Labor Productivity Is Highest." Statista Infographics, 27 May 2019, https://www.statista.com/chart/16905/gdp-per-hour-worked-across-the-total-economy/; **530 Organisation for Economic Co-operation and Development: OECD,** *Comparative Economic Performance in OECD Nations (Paris: OECD, 1989), p. 66,* http://www.oecd.org; **536–537**

Statistics Japan: Statistical handbook of Japan (2018), Japan Ministry of Finance, p.126; **545 From The World's Largest Public Companies, Forbes Media LLC. Forbes.com. © 2020 Forbes. All rights reserved. Used under license. https://www.forbes.com/global2000/list/#country:Japan. Permission obtained from Forbes through PARS**; **545 Tuttle Publishing:** J. C. Abegglen and G. Stalk, Jr. *Kaisha: The Japanese Corporation* (Tokyo: Tuttle Publications, 1985); **548 JPMorgan Chase & Co:** J.P. Morgan's 2017 Japan Cross; Border M&A report with data from Dealogic and Thomson One report as of March 31, 2017; **563 US Department of Commerce:** *Summary of the US–Canada Free Trade Agreement* (Washington, DC: US Department of Commerce, International Trade Administration, 1988), p. 12; **564 International Monetary Fund:** Adapted from IMF, Direction of Trade Statistics Yearbook, 2000, 2009, 2014 and 2018; **566 World Bank Group:** Population, total, The World Bank Data 2017; **569 Air Transat:** Air Canada in exclusive talks to buy Air Transat, CBC News, May 16, 2019. Used with permission from Air Transit; **573 Postmedia Network Inc.:** The financial post, National Post FP500, 2017; **580 Eastman Kodak:** J. R. D'Cruz and Alan M. Rugman, *New Concepts for Canadian Competitiveness* (Toronto: Kodak Canada, 1992); 589 Quote by Stan Shih **593–594 United Nations Conference on Trade and Development:** Adapted from United Nations, *World Investment Report*, 2006, 2009, 2014, 2018; **596 United Nations Conference on Trade and Development:** From The world's top 100 non-financial MNEs, ranked by foreign assets, 2018, Annex table 19, UNCTAD © 2018 United Nations. Reprinted with the permission of the United Nations; **603 Penguin Random House:** Adam Smith, *The Wealth of Nations*, Book IV: 2, Modern Library edition, 1776; **610 Quote by R. K. Krishna Kumar 613**

NASSCOM: NASSCOM Report, http://www.nasscom.in; **614 India Brand Equity Foundation:** IT-ITeS Report, July 2018, India Brand Equity Foundation. Used with permission; **614 Pearson Education:** NASSCOM and McKinsey Perspective 2025; **615 India Services, Ministry of-Commerce and Industry:** Adapted from Information Technology & Information Technology enabled Services Overview, India Services 2018; **622 Cambridge University Press:** 'Making it in China' session at the-University of Cambridge; 622 Hayward Tyler Ltd (2008). (2018, February 23). Retrieved from https://haywardtyler.com/about/awards/; **624 The World Bank Group:** Data Bank, World Development Indicators, The World Bank; **624 United Nations Conference on Trade and Development:** Annex Tables, United Nations Conference on Trade and Development, 2019; **625 United Nations Conference on Trade and Development:** UNCTAD, World Investment Report, 2011–18; **626 Springer:** Jeffrey B. Miller and Stoyan Tenev, 'On the role of government in transition: the experiences of China and Russia compared', *Comparative Economic Studies*, vol. 49 (2007), pp. 543–71; **627 Quoted by Hu Jintao 628 World Economic Forum:** Adapted from Emma Charlton, China is building 8 new airports every year, World Economic Forum 24 Aug 2018; **633 Hachette UK:** This is a quote from Tim Clissold's book, *Mr. China*, taken from 'The Battle of Ningshan' in *Journey to the West*, an unattributed sixteenth-century Ming dynasty novel; **636 Springer:** Randall Morck, Bernard Yeung and Minyuan Zhao, 'Perspectives on China's outward foreign direct investment', *Journal of International Business Studies*, vol. 39 (2008), pp. 337–50; **637 Fortune Media IP Limited:** Search Global 500, Fortune Global 500 list, Fortune; **639 Statista, Inc.:** Adapted from Agne Blazyte, 'Alibaba continues to lead retail e-commerce sales in China in 2018', Statista, July 17, 2018.

FRAMEWORKS FOR THIS BOOK

Our Approach to the Study of International Business

Figure 1 sets the scene for this entire book. Our approach to understanding international business focuses on the interrelationships between the firm and its environment, at several connected levels. Multinational enterprises (MNEs) are firms (small and large) that have expanded to source inputs or sell outputs internationally. They are at the centre of our framework.

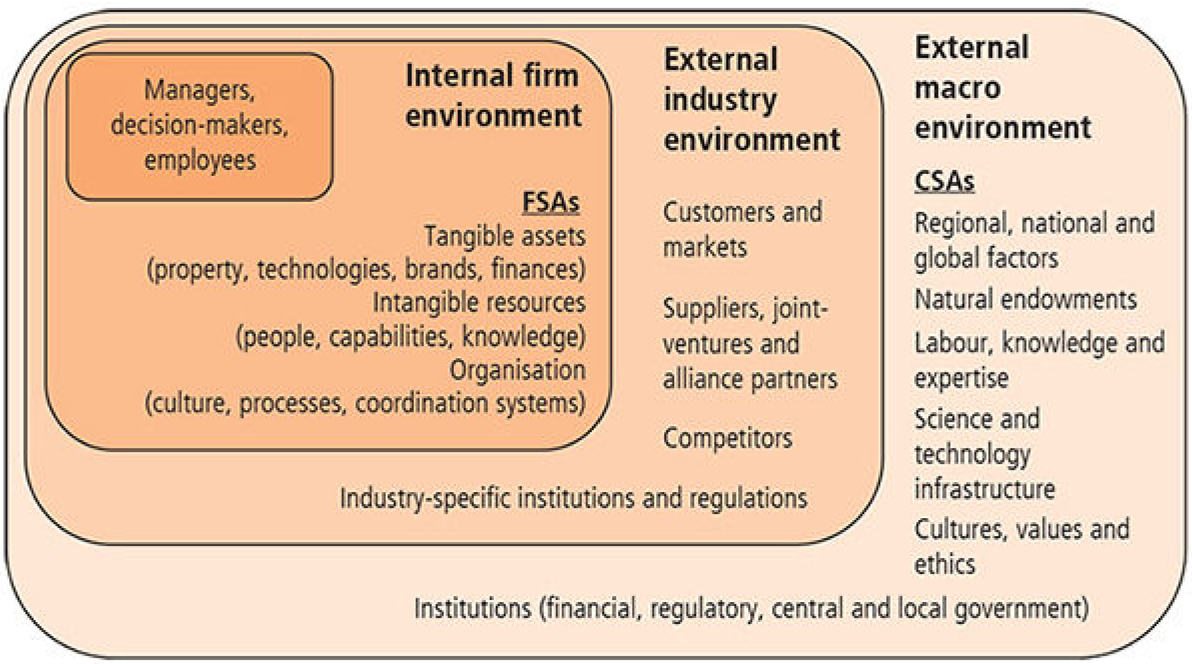

Figure 1 The multiple, interacting levels and lenses of international business studies

International managers in MNEs make decisions based on their understanding of this environment and the (tangible and intangible) assets, resources and capabilities they can coordinate internally to help their firms succeed. In this evolutionary sense, managers and their firms need to adapt in response to an ever-changing competitive environment in order to

survive. There are opportunities to create alliances with partner firms, or benefit from new technologies, improve productivity, innovate, and develop new products and services to attract more customers. But there are also threats from competitors that can exploit these same opportunities faster or more effectively.

Overall then, we look at how well 'firm-specific' assets (FSAs), resources and capabilities are aligned with the host country environments (country-specific assets, or CSAs) in which MNEs operate. The 'dynamic capability' of firms depends on the ability of decision-makers to maintain this alignment in a changing world, evolving FSAs to exploit external opportunities and cope with new threats. We make a distinction between the external industry environment and the external macro environment. The former is comprised of the specific threats and opportunities influencing the behaviour of firms that collaborate or compete directly with each other in a particular industry sector (automotive manufacturing, insurance services, container shipping, etc.). The latter represents the broader, global context comprised of a complex range of different country markets, institutions and cultures around the world. Country markets present opportunities (or 'location advantages') such as access to inputs like lower-cost labour, cheaper resources, new technology or expertise, or access to new customers. But this access may be constrained by local competitors, institutions, and regulations or different ways of doing business. One core aim of international business studies is to better understand these differences and how MNE decision-makers can cope with them.

At the macro environment level, it is important to understand how the interrelationships and interdependencies between countries are changing over time. The opening up of emerging markets, the growing dependence on China as a market and a source of manufacturing products, and the

shifting nature of regional blocs (such as the EU) are the kinds of key changes that have implications for whole industries, each MNE, and individual decision-makers. Trade and FDI data help map these macro-level changes. As places (countries, regions, cities) compete to be net exporters and net recipients of inward investment, these empirical data show who are the winners and losers.

At the industry environment level, global value chains, buyer–supplier relationships, joint ventures, and alliances between co-dependent firms that specialise in different products and services all connect competing locations. MNEs derive competitive advantage by linking different places via these kinds of mechanisms. They leverage the benefits that come, for example, from buying or making products in one place (where cheap labour and other location advantages exist) and selling them in another, where disposable income and prices are high. They also benefit by integrating the knowledge and capabilities that exist in different locations to add value to products and services sold in other locations. All firms are brokers, but by definition MNEs are brokers that trade globally.

A full insight into the shifting complexities of international business requires a combination of theories, frameworks, concepts, tools and examples from across the social sciences, including economics, political science, sociology and human geography. Each of these disciplines explains a different set of factors operating at each of our levels of analysis, micro to macro. They also bring different ‘tool kits’ to answer our questions. Put them together and we have more powerful and convincing explanations of how the world works. So, our approach is explicitly multidisciplinary.

PRACTICAL THEORY

Kurt Lewin (one of the founders of social psychology) famously said, 'There is nothing so practical as good theory.' Good theory is useful as well as being evidence-based and broadly applicable to different contexts. Good theory, alongside key frameworks and concepts which simplify and explain the way the world works, can guide effective decision making by turning information into knowledge and knowledge into real-world wisdom.

This book takes a number of different perspectives to improve our understanding of international business. We take on the role of objective observers, compiling data and evidence to map trends and make predictions. Data on trade, foreign direct investment, global mergers and acquisitions (M&As), regulatory changes, the largest MNEs, and the fastest-growing SMEs (small and medium-sized enterprises) all help us understand what is going on in the world.

We also take on the role of decision-makers, putting ourselves in the shoes of government policy developers and (more often) practicing managers. A key question that runs through the book is: what are the main challenges facing an MNE manager, trying to enter new country markets and coping with very different country contexts?

Figure 2 outlines a series of decision stages for managers involved in the process of international expansion. The why, what, where and hows (and really, how?) of internationalisation are mapped on to some of the core concepts and frameworks featured in the book. Decision-makers have a wide range of strategic choices, which they make in the face of ever-changing opportunities and threats. The success of a firm, in fact its very

survival, depends on its decision-makers making more right decisions than wrong ones. Firm sales revenues, profits and other measures of performance allow us to judge whether the right decisions have been made, both over time (looking at data trends over the years) and relative to competitors (comparative benchmarking). The list in the right-hand column shows some of the main analytical concepts and frameworks we use to address the key questions for decision-makers that are guiding the international expansion of their firms.

One of the measures we use is the 'Transnational Index' or TNI. This indicates how multinational a firm is by adding up three ratios: foreign sales as a percentage of total sales, foreign assets as a percentage of total assets, and foreign employment as a percentage of total employment. A low TNI (below 20 per cent) shows that a firm is domestic market-oriented and not very multinational. Researchers have explored the relationship between multinationality and performance and found that there is no simple correlation.

Both quantitative and qualitative approaches are necessary to get more complete explanations of the internationalisation journey. Each of the chapters in our book (with the exception of Chapter 1) features five case studies of different kinds and these provide real-world stories about how specific firms (or, in some cases, industries or countries) have coped with particular international business challenges.

But our interest in this book goes beyond an understanding of what makes managers and firms successful – whether success is measured in profitability, providing employment, or just expanding in scale and becoming more powerful. We are interested in how MNEs and their activities affect the 'rest of us'. In responding to external change MNEs have a significant impact on our world. They provide most of our products

and services and employ millions of people. *How* they do this and *where* they do this affects not just international trade and investment, but local communities, our shared environment, and most people's employment opportunities. One of our key aims is to help you, the reader, to *critically appraise* the effects of their actions. In what ways are they a positive or a negative force in our world? A substantial part of the book also discusses how government policies and the activities of non-government organisations (NGOs) influence the behaviour of MNEs.

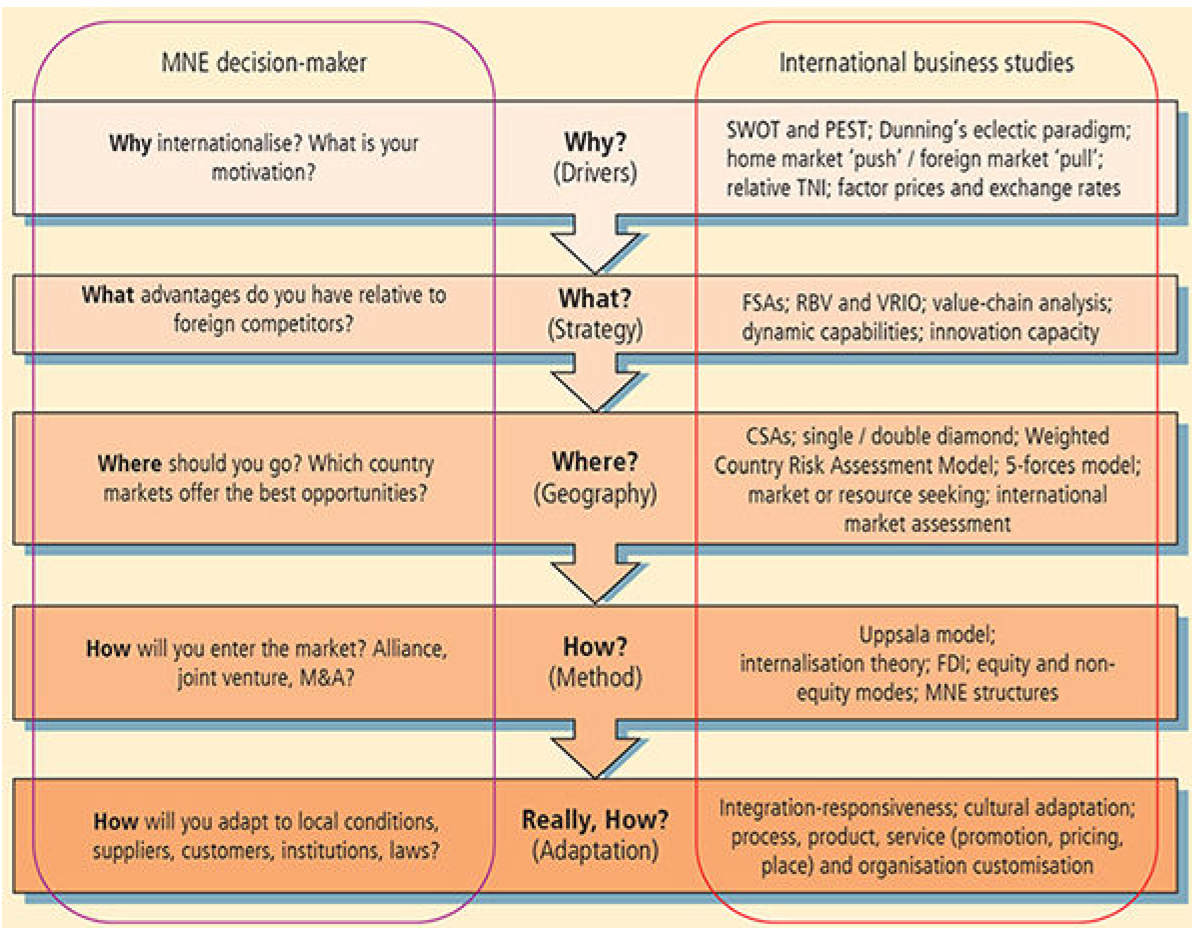

Figure 2 The internationalisation roadmap: decision stages for global expansion

So, our textbook uses multidisciplinary approaches, quantitative and qualitative methods, empirical data and real-world case studies to examine and understand the motivations, actions and effects of multinational firms,

large and small, at multiple levels of analysis. In the final introductory section, we provide an overview of how all of this material is structured through the book.

THE STRUCTURE OF THIS BOOK

Chapter 1 is slightly different in structure from the other 19 chapters in this book as it introduces the field of international business and contains no case studies. Each of the remaining chapters opens with a set of contents and key objectives and an 'Active Learning Case', with learning checks throughout the chapter which ask (and answer) a series of questions relating the issues covered in the text to this opening case study. Two 'International Business Strategy in Action' case studies and two 'Real Cases' also feature, the latter coming at the end of each chapter. Key learning points and key terms as well as review and discussion questions also appear at the end of each chapter alongside a bibliography presenting references and further reading.

Figure 3 shows how the book is structured to cover the different aspects of international business across the levels of analysis outlined in Figure 1. There are five major parts. Part One contains the introduction and Chapters 2 and 3. We introduce some key frameworks and explore why and how firms become MNEs. Part Two covers the macro environment and discusses how political, cultural, and institutional contexts vary by region and require MNEs to adapt. Financial transactions and institutions and trade are given particular attention. This part looks at how places vary and how they interact, compete, and develop particular interdependencies.

Part Three shifts the emphasis toward the MNE and the decision-maker to examine how different international business strategies are appropriate in different global contexts. The interplay between strategy and structure (or 'organising strategy'; Chapter 9) is a central theme. As Alfred Chandler observed, these evolve in tandem. A firm's structure and organisation

enable some strategic options and limit or exclude others. So MNE structure shapes strategy. Strategic choices in turn require structural changes as the firm must reorganise its divisions, resources, and people to implement new initiatives, like entering a new overseas market. So, strategy shapes structure. Chapter 10 focuses on the diamond models of advantage and the integration-responsiveness framework.

Part Four takes a more detailed look at some specific functions within MNEs: production, marketing, HRM (human resource management) and finance. These are specialist areas of business and management studies in their own right and we focus on the international dimensions of these functions and the ways in which they can facilitate effective international strategies. Chapter 14 presents the 'Weighted Country Risk Assessment Model' as a framework for guiding the 'where' and 'how' decision steps outlined in Figure 2. It allows decision-makers to compare country markets and different modes of market entry as a precursor to investment.

Finally, Part Five presents five regional (macro) environments and discusses some specific international business strategies for 'coping' with them. We provide an overview of the political, socio-cultural, economic and institutional characteristics of these key countries and regions, alongside case studies of both foreign MNEs and local firms. MNEs are distinctive because they have successfully leveraged their FSAs to establish themselves in these markets, learning about the differences and adapting accordingly. Local firms have evolved and stayed in these environments and reflect particular strengths, weaknesses, and characteristics that will underpin their ability (or inability) to eventually expand internationally and become MNEs.

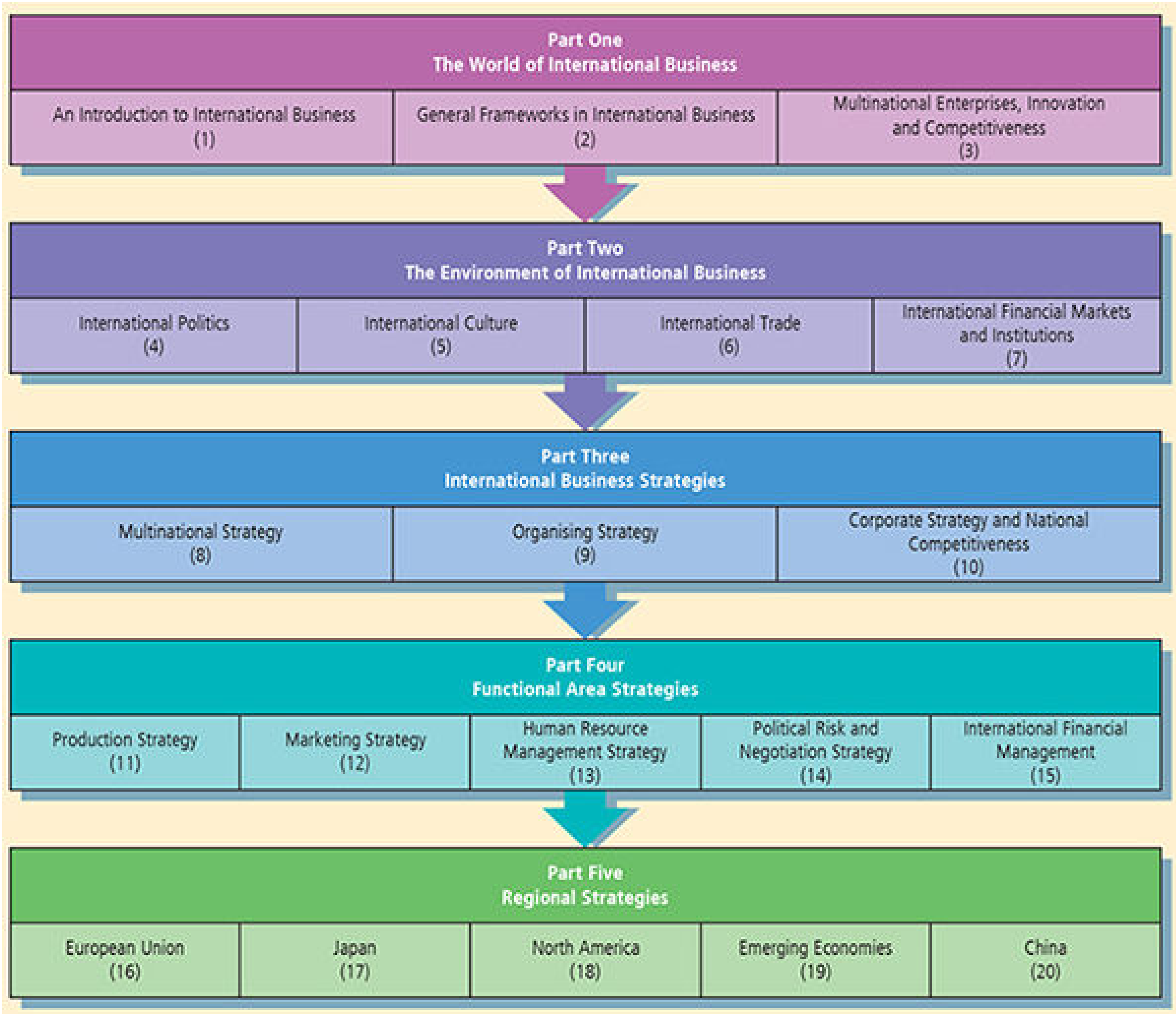

Figure 3 **The structure of this book**

Part One

THE WORLD OF INTERNATIONAL BUSINESS

Chapter 1

AN INTRODUCTION TO INTERNATIONAL BUSINESS

Contents

Objectives of the chapter

In this chapter we are going to define the boundaries of the field of international business in an introductory overview of the main themes of this book. We will examine trends in international business, keeping in mind how globalisation has evolved over the last century. We will examine some of the worldwide economic and political changes that are taking place and look at how globalisation (and its constituent elements) is altering the way international business is conducted.

We will then focus on innovation and technology, and discuss how they lie at the core of greater interdependence, which is one of the defining features of globalisation. After this, we look at social political developments and institutions, which effectively define how businesses conduct their operations. Understanding institutions, both formal and informal, is important for both firms and employees, so they can adjust their behaviours accordingly. We then discuss how supranational agreements try to harmonise some of these institutions, such as the World Trade Organization, which has led to the liberalising of markets between member states and has been used to solve disputes. The next section looks at multinational enterprises (MNEs), which are at the core of spreading globalisation, and we examine their controlling investments abroad, otherwise known as foreign direct investment, which will be a key feature throughout this book. We also trace the rise of MNEs to the present day. MNEs are not the only important actor in international business; so are small and medium-sized enterprises (SMEs), which will also be examined in this chapter. Finally, we discuss global value chains and networks, and show how products are assembled through firms that are based in several countries.

The specific objectives of this chapter are to:

1. *Define* the boundaries of the field of international business in an introductory overview of the main themes of this book.
2. *Examine* how worldwide economic and political changes have driven globalisation and shape the way international business is conducted.
3. *Highlight* innovation and technology as major factors underlying global economic growth and greater interdependence between firms and countries.
4. *Introduce* some of the main actors that feature throughout this book: multinational enterprises and small and medium-sized enterprises, which are at the core of spreading globalisation; value chains and networks, which connect firms globally; and institutions (national and global), which shape how these other actors evolve.

INTRODUCTION

Chapter 1 provides an introduction to the field of international business (IB). We begin by drawing the boundaries of the field of IB, its main definitions and concepts, and then introduce the main activities and stakeholders in IB and discuss their roles and inter-relations. We provide an overview of worldwide economic and political changes as a background to understanding the process of globalisation and its main driver, the multinational enterprise. The section concludes with a discussion of new developments in international business. Specifically, we discuss both the emergence of emerging economies and the growth of non-equity mechanisms, paying particular interest to the growth of global value chains.

WHAT IS INTERNATIONAL BUSINESS?

The world of **international business** is a wonderful and exciting field of study. The 'international' in 'international business' is superfluous because globalisation has meant that all business is to some degree international. Today it is almost impossible to find a product or service that does not have an international aspect to its customer base, as well as at least one element of its supply chain. By supply chain, we refer to the chain inputs that come from other sources, including the raw materials, components and equipment used to produce, store and package the product or service. Therefore, in this book we approach IB as a study of business.

We define international business as the study of transactions taking place across national borders for the purpose of satisfying the needs of individuals and organisations. There are many forms of international business transactions. The 'classical' view of international business has been international trade, in the form of **exporting** and **importing**. Trade is about transactions between actors that are physically located in different places. These actors may be in the same country, but located in different cities, states or provinces, for instance. They may also be in different countries, in which case the activity is known as **international trade**. International trade continues to grow, and remains core to the world economy. According to the United Nations Conference on Trade and Development (UNCTAD) the exports of goods and services in 2017 was worth US$22,7 trillion, an almost six-fold increase from US$4 trillion in 1990. (By definition, the total world exports will be equal to the total world imports, so it is axiomatic that exports have grown as fast as imports.) In this book, when we refer to trade, we implicitly assume that this refers to international trade. Trade is not new,

as human beings have been engaged in bartering goods since the dawn of civilisation. International trade is also not new – we know that early Egyptians, Assyrians, Indians and Chinese all systematically traded with each other. Indeed, as we shall discuss later, trade has been the driving force of economic growth and has been a driving force for globalisation.

Since the beginning of the twentieth century, the key change has been the growth of the international firm, with operations and activities that are directly (and actively) controlled in overseas locations. Such operations are known as *affiliates* or *subsidiaries*. These international firms are known as **multinational enterprises (MNEs)**, and although the casual observer may think of them as large behemoths like Google, Huawei, IBM, Iberia, Hon Hai, Reliance, etc., a majority of MNEs are small and medium-sized (e.g., Codex, Acro Aircraft Seating, SafeGuard World International and Mind Gym). While you may not have heard of these companies, they are important partners and suppliers to their larger, more famous counterparts. For example, Walt Disney Studio's *Star Wars: The Last Jedi* relied on video recording equipment supplied by UK-based SME Codex.[1] Moreover, small and medium-sized firms also dominate the landscape of almost every country. For instance, firms with fewer than 200 employees accounted for 98 per cent of all firms in Taiwan in 2017 and employed 80 per cent of the workforce![2]

International firms are responsible for about one-third of global trade, much of which moves between affiliates: that is, these goods and services are being exchanged across borders but within the same MNE. Large MNEs – through various linkages – have considerable influence on other non-affiliated firms as well, because they depend upon a vast array of other firms to supply them with various inputs, intermediate goods and supplies. Smaller firms are dependent upon a variety of larger MNEs as customers. Indeed, the total effect – which is hard to estimate accurately – is that possibly *half* of

the global economic activity is in one way or another dependent upon international business and MNEs of all sizes.

The principles of trade are well known, having been a subject of study at least since the 1700s, and the principles and processes by which trade is undertaken are very unambiguous. Chapter 6 deals with international trade in considerable detail. Our interest in this opening chapter is to place the global economy and international business into context, and the novelty here is the role of the international firm, and how it undertakes international business.

The reader will have noted that we have not used the term ‘global firm’, but instead we refer to ‘international firms’ or ‘multinational enterprises’. There are few firms that are truly global, and it is a common error to use the word ‘global’ as a synonym for ‘international’. This error lies in the failure to understand globalisation, and therefore we begin this chapter by clearly defining globalisation. We will then go on to explain how the MNE and international business have evolved, and how the intertwining of so many disparate factors has created the complex tapestry that is today’s global economy.

GLOBALISATION

There is little doubt that we live in a world defined by globalisation. Globalisation, however, remains a vague concept, used by different people in different ways. It is also a divisive subject because many of the social, political and economic problems in the world today are attributed to the negative effects of globalisation, while others regard it as a force for positive change. In this book we do not seek to take sides in the debate about the pros and cons of globalisation, or to engage in a discussion of 'making globalisation good'. It is simply a fact of the twenty-first century, and it is an ongoing *process*, rather than an *event*. In this book, we focus on **economic globalisation**. We define economic globalisation as *the growing interdependence of locations and economic actors across countries and regions*.[3]

By referring to economic actors we are able to include very small actors (such as individual entrepreneurs), or very large ones (such as a nation-state, which itself consists of individuals), as well as firms of all sizes. We use the term 'economic actor' deliberately to include not only MNEs, but all formally and systematically organised entities (such as non-governmental organisations, clubs, associations, charities, governmental organisations, state-owned firms, hospitals, research centres and universities), each functioning (however imperfectly) as a clearly delineated single organisation for the generation of a specific set of outcomes or goals defined by their stakeholders. These may be the generation of profits, the provision of jobs, reducing poverty, or some other goal, and they seek to act as a single cohesive unit towards the achievement of this goal. The logic of how each economic actor interacts internally follows similar principles, and they are

seen by other actors as a cohesive single unit, regardless of the nature of its intended goal, or its size.

The outcomes of globalisation

As summarised in Figure 1.1, globalisation has manifested itself through certain very clear outcomes. Most obviously for the study of IB, there has been a greater interdependence of locations (whether countries, regions or cities) and an interdependence of firms.

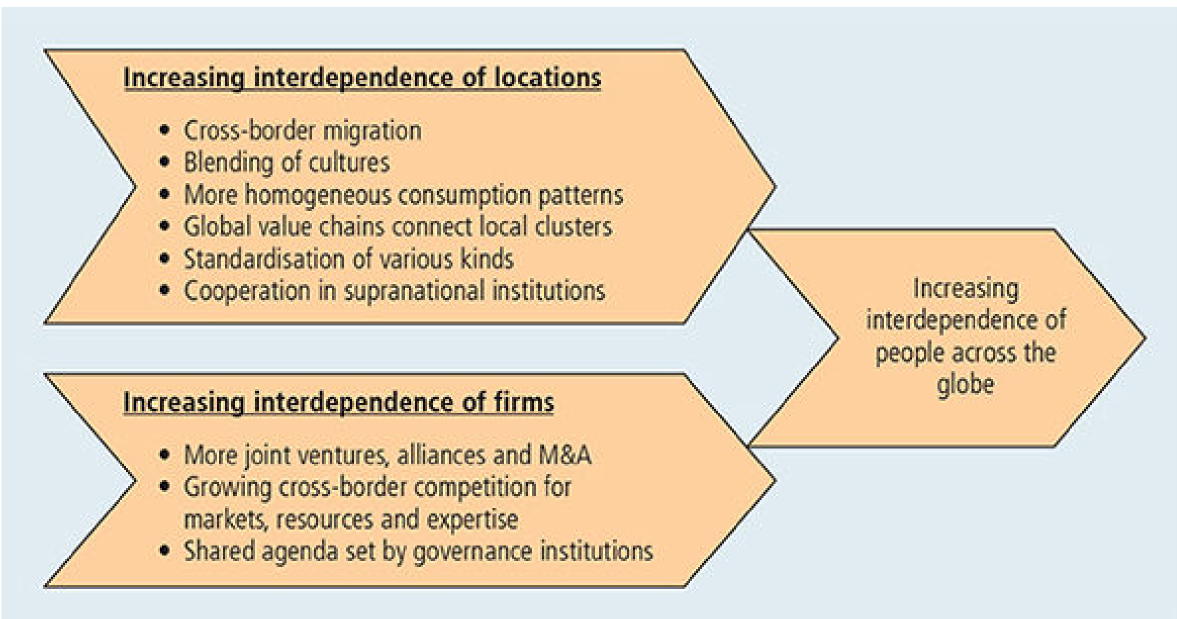

Figure 1.1 The consequences of globalisation

The *interdependence of locations* is an especially complex issue, and is associated with the growth of the international firm. At the most basic level, the growth of trade has reduced distances, and the concurrent growth of MNEs has accentuated this trend. The borders of countries (and cities and regions) have become increasingly blurred, because the economic actors located within that location also have operations in multiple other locations. At the country level, it affects the identity of the nation-state. On the one hand, countries remain sovereign and independent, while on the other hand,

they are increasingly swayed by developments outside their borders. Currencies are floating, and their values are determined by the vagaries of currency traders the world over, and by political and economic developments not just in neighbouring countries. Should a government decide to raise corporation taxes for companies located within its borders, this does not mean that there will be greater tax revenues. Higher tax rates in one country can motivate firms to relocate their operations to a lower-tax country. The declining sovereignty of countries reflects itself in the fact that home country governments can intervene directly to influence the investment decisions of their MNEs, and few countries can afford to make policy decisions without considering what other countries are doing. Government policies have to tread a thin line between responding to international developments and to domestic priorities. Countries in the EU cannot make laws that contravene EU laws; members of the World Trade Organization (WTO) must adhere to the rules of the WTO.

At the same time, this does not mean countries have no distinct identity: there are clearly defined characteristics and patterns that are history-dependent and idiosyncratic, such as areas of specialisation, technological competences, structure of markets, consumption patterns and culture. Although at a policy and international business level, countries have less independence, at a sociological, cultural and political level they remain distinct. These differences continue to matter, and despite the rhetoric, there is little evidence that there is significant convergence at these levels.

The *interdependence of firms* has taken place through alliances, joint ventures and outsourcing activities and is a distinctive feature of globalisation. Collaboration by economic actors is happening in ever-greater numbers with every passing year. This is a phenomenon that has sparked the attention of managers, policy-makers and academics alike. Some believe that this phenomenon is the death knell of the traditional firm, that firms will

become increasingly ‘virtual’, although we think this idea is somewhat exaggerated. Although collaborative activity is not a new practice, it is undeniable that there has clearly been a process of evolution whereby there is an increasing use of alliances explicitly for strategic purposes. Its novelty is not as an organisational form – economic units have collaborated for millennia. Intricate linkages between economic entities that create informal and formal networks to undertake value-added activities date back to before the seventeenth century. Rapid Japanese industrial growth over the last century has been partly attributed to the cooperation between interlinked firms with limited equity cross-holdings within industrial groups referred to in the post-World War II era as *keiretsu.* What is unique about today’s collaboration between firms is its widespread use by firms of all sizes and nationalities, and its use in a growing variety of activities such as R&D, manufacturing, sales, distribution and logistics. Furthermore, cooperative activity has a growing international element, and it is not just limited to related firms but is often undertaken with international competitors.

It is important to point out that just because it seems that globalisation is leading towards a convergence of consumption patterns and the global presence of certain firms, products and services, convergence does not imply uniformity. Just because consumer preferences have become similar, this does not mean they are the same. Markets are simultaneously local as well as global, and in some instances they may remain local. Coca-Cola is an example of a firm that advertises and sells the same product on a global basis. This seems to work most of the time for Coca-Cola, but homogeneity in consumption patterns in the food and drinks industry is rarely achieved. A good example of this is the soft drinks market in Indonesia, which, despite Coca-Cola’s considerable marketing efforts, continues to be dominated by unsweetened and non-fizzy tea. A local firm, Sinar Sosro PT, continues to dominate this market, with a 58 per cent share in 2014. A similar example is

the coffee market in Italy. Despite priding itself on its Italian inspiration, Starbucks only entered the market in 2018 with its Starbucks Reserve Roastery in Milan. With operations in over 78 countries, it took Starbucks 47 years to target the local Italian market, which is highly distinct in terms of taste and preferences due to the 'Italian coffee culture'.

Large companies like Nestlé and Unilever have carefully plotted a course that allows them to differentiate between those product lines that can be marketed and produced regionally, locally or globally (we will discuss the integration-responsiveness framework throughout this book, particularly in Chapters 8, 9 and 10). Other markets, such as banking services and mobile telephones, have shown considerable market convergence. Even in such sectors, there are limits to how far and how fast convergence has occurred. Despite HSBC's huge investment in announcing itself as a 'global' bank operating under one brand since the 1990s, and with global technological platforms to allow seamless activity across borders, in 2015 HSBC announced its intention to disinvest from a number of key markets, such as Brazil and Turkey, and return to being a regional, Asia-based player.[4]

Understanding interdependence in globalisation

There is a tendency to mistake internationalisation for globalisation, and the key to differentiating the two is the issue of **interdependence**. Interdependence is the essence of globalisation, and as usual, it is a continuum, with firms, individuals and countries demonstrating different degrees of interdependence. Understanding globalisation requires us to appreciate the increasing degree of interdependence between economic units, whether firms, individuals or countries.

The term 'interdependence' has a very specific meaning. It refers to a mutual reliance between groups of actors, and the degree of this mutual reliance can vary considerably. Members of a soccer team are typically

deeply interconnected, with a high degree of interdependence. The sudden departure of a key player in a team can severely affect the efficiency of the team as a whole, and can endanger its very survival. The decision of the United Kingdom to withdraw from the European Union in June 2016 ('Brexit') will prove to be very difficult to implement because both the EU and the UK are highly interdependent, and are bound very tightly together. There are at least 759 agreements to be renegotiated,[5] including agreements with non-EU partners.

The key issues are the degree of *centrality* and *reciprocity*. Reciprocity refers to the degree to which the reliance is two-way. Take the case of the USA and India. Their economies are obviously interdependent. However, the relationship is unequal. As an economic, political and military superpower, the US has greater economic and political clout, and has greater influence in shaping the rules that define their interaction, while India remains peripheral in international affairs outside South Asia. Likewise, when it comes to economic activity, there is a strong imbalance. Over a third of India's exports go to the US, but for the US, India is only its thirteenth largest destination for exports, just after Taiwan, a country many times smaller. The United States enjoys a much more 'central' status within the global economy, while India is less central and more towards the 'periphery'. On the other hand, India has a higher centrality than Vietnam or Kenya, given its larger economic size and its geopolitical position.

The last two decades have seen China, and some East Asian economies (such as Taiwan, Korea, Singapore and Malaysia) become increasingly central compared with Laos, Vietnam or Bangladesh. Much of Africa is firmly within the periphery. It is not only about physical size, or the lack of natural resources or markets. The Netherlands and Belgium are small in these terms, but have high centrality, whereas Norway, Finland and New Zealand are on the periphery, but are less integrated into the world economy.

A more central economy is one which plays a significant role as either host or home to MNEs; engages in considerable trade in intermediate and manufactured goods; contributes greatly to innovation and scientific progress; is strongly linked or accessible physically to other central countries, through strong infrastructure, transport, and communication links; and plays a significant role in decision making within supranational organisations.[6]

It has become increasingly obvious that many more peripheral countries are unable to make and implement economic decisions unilaterally because in these economies MNEs from more central economies that are major players in international markets determine prices, and the central economies' banks determine lending, and therefore exchange rates, and the value and use of resources. Peripheral countries have to consider external and foreign conditions and actors in making economic decisions, and are thus more or less obliged to consider external (non-domestic) dimensions. They are *dependent* rather than interdependent on other more central countries, through supranational institutions as well as firms.

Interdependence is not just a country-level phenomenon. Economic actors come in all sizes. Large MNEs matter more than others because they are often large and powerful: the largest MNEs have revenues greater than the GDP of many countries. MNE-based industrial development policies are now commonplace among most countries.[7] There is also increased competition for MNE investment, particularly investments that provide opportunities for technology transfer, employment, and capital. Firms of all sizes are increasingly integrated with firms, customers, suppliers, governments and organisations in other countries.

Regional integration

One of the most visible outcomes of globalisation is economic integration, and this is happening naturally as a result of growing interdependence. However, at the same time as 'natural' integration takes place because of growing MNE and trading activities, and the greater interdependence due to supranational organisations, common institutions, etc., there is also a process of *formal regional integration*. Most often, countries that are geographically proximate set up formal agreements to create 'groups' that seek in large part to increase **foreign direct investment (FDI)** and trade within their region, consequent from increased opportunities to exploit economies of scale. Smaller and more peripheral countries also hope that it will increase their bargaining power with larger and powerful 'central' economies. Interdependence caused by globalisation is more a consequence of increased cross-border activity, while regional integration is intended to *cause* it.

There is no question that globalisation has resulted in economic integration. This has led to a revival of previously unsuccessful or dormant schemes and the establishment of a number of new agreements. Although estimates vary, there are more than a hundred regional integration schemes in existence. Part of this enthusiasm has to do with the benefits that have accrued to members associated with the EU and NAFTA. The latter lasted from 1994 to 2018, when it was renegotiated among the three member states, the US, Canada and Mexico, resulting in a new agreement, called 'USMCA'. This new deal, together with Britain's 2016 decision to leave the EU, shows that nations perceive the benefits associated with regional integration schemes differently.

There are several similarities between globalisation and regional integration. Both are processes and closely associated with cross-border economic activity, although globalisation is more a consequence of increased cross-border activity, while regional integration is intended to cause it. Both globalisation and regional integration are believed to provide opportunities

for more rapid economic growth, associated in large part with increased FDI and trade that are consequent from increased opportunities to exploit economies of scale.

The single largest and most comprehensive regional integration scheme is the European Union. This group of nations, whose history and current developments will be discussed in Chapter 17, was formed by six countries in the late 1950s. Today there are 27 members of the EU.[8] This includes the EU15 – Austria, Belgium, Denmark, Finland, Germany, Greece, France, Ireland, Italy, Luxembourg, the Netherlands, Portugal, Spain, Sweden and the UK – an additional eight eastern European countries that joined on 1 May 2004 – Czech Republic, Estonia, Latvia, Lithuania, Hungary, Poland, Slovenia and Slovakia – as well as Cyprus and Malta. Bulgaria and Romania became members of the EU in 2007 and Croatia joined in 2013. The collective GDP of the EU is greater than that of the United States or Japan, and the economic data show how important the EU is in the international arena. For example, in terms of imports and exports, the EU accounts for 15 per cent of world imports and exports, with its main partner for exports being the United States and for imports China.[9] A large portion of EU exports is in the form of intra-EU trade, which was 75 per cent higher than EU exports leaving the EU (extra-EU trade) in 2014 (see Chapter 17).

Mapping globalisation

It is not straightforward to map globalisation: globalisation has to do with the intertwining of a number of social, economic and political factors, and the problem is that it is all linked to human behaviour and action. Understanding human behaviour is unfortunately not a science but a *social science*. The beauty of science is in its clear-cut boundaries. An experiment in physics or biology can be repeated with exactly the same results, regardless of by whom or where or when. Furthermore, it is possible to

exclude certain processes in the repetition, to create a ‘control’, in order to clearly determine cause and effect. In the social sciences, we are obliged to throw in a *ceteris paribus* (Latin for ‘all else being equal’) clause. In order to test arguments we sometimes introduce numerous restrictive and often implausible assumptions. Unfortunately, all else rarely is equal. Thus, with globalisation we are only able to say that there are numerous factors that are interrelated, but we are unable to be certain about the causality or the relative importance of each factor.[10]

Figure 1.2 maps out the primary forces underlying globalisation; the dynamic interactions and interdependencies that drive it forward. The main forces that shape globalisation are:

- Those associated with *socio-political developments*. Political decisions (or indecision) shape the success or failure of firms, and the competitiveness of countries. Liberalisation and the preferred policy orientation of a country play a significant role in shaping economic policy.
- Those associated with *technology* and *innovation*. The ability of firms to be successful depends ultimately on their ability to generate new ideas through innovation, and obviously firms shape the competitiveness of the location they are in. We discuss this in much greater detail in Chapters 3 and 10.

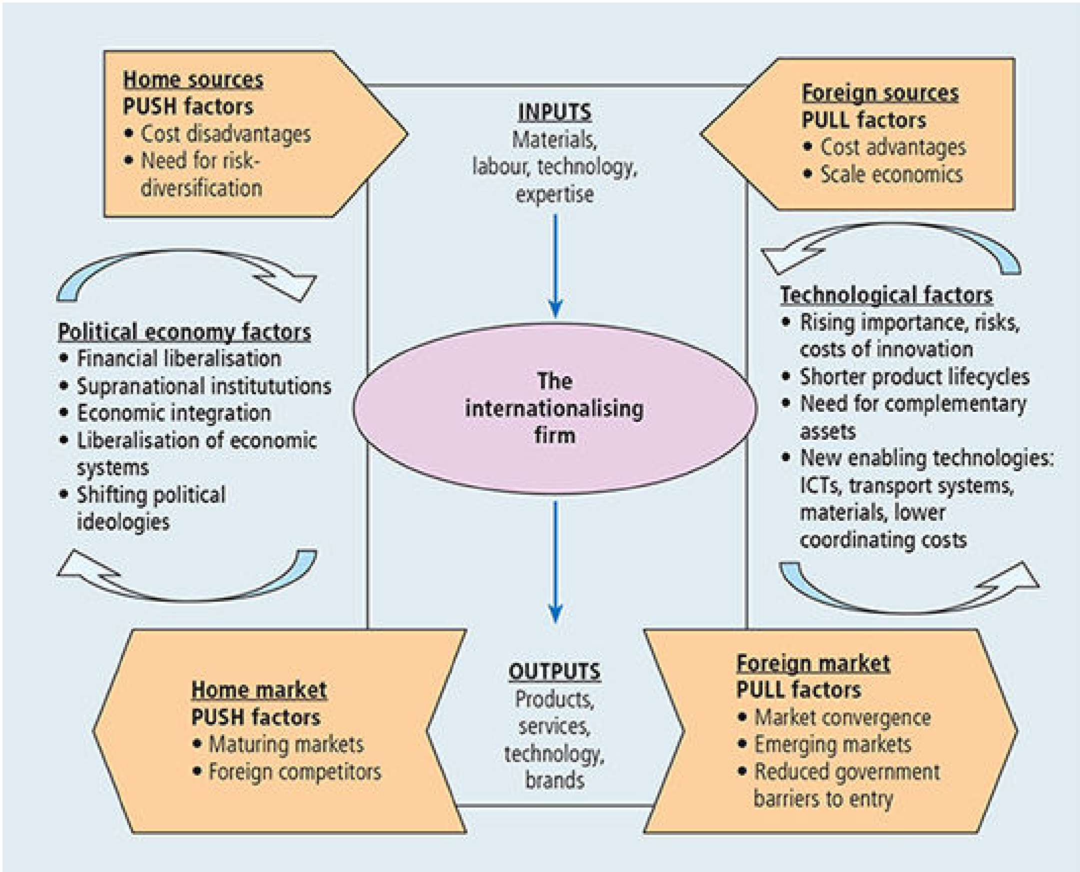

Figure 1.2 The dynamics of globalisation

There are an assortment of 'push' and 'pull' factors as well, which affect the capacity of a firm to internationalise (Figure 1.2). At the **upstream** end of the firm's activities, it must balance push factors arising from rising prices of inputs that encourage it to go abroad to seek cheaper inputs. At the same time, these activities are 'pulled' abroad because there are scale economies from relocating these activities in foreign locations.

Likewise, at the **downstream** end, closer to the final market and the customer, there are a variety of push and pull factors. The home market may be mature, and firms need to seek new opportunities for growth in new and faster-growing countries (push factor). On the other hand, there may be barriers to exports that encourage the firm to relocate production overseas, acting as a pull factor.

TECHNOLOGY AND INNOVATION

Technological change and innovation are acknowledged almost universally as determinants of globalisation. Technology implies the application of scientific knowledge for practical aims. It involves applying scientific concepts that help us understand our environment, and allows us to convert this knowledge to develop and fabricate artefacts. Technology and science are *cumulative*, and build upon previous science and technology. The *practical* dividing line between science and technology is not always clear. Science and technology advance through *innovation*, which represents change in the stock of knowledge. Technology and science are subsets of knowledge.

Innovation means the introduction of *any* novelty, but there is an important distinction between 'invention' and 'innovation'. An invention is an idea, sketch or model of any new or improved device, product, process or system. Innovations only occur when the new product, device or process is involved in a commercial transaction. Multiple inventions may be involved in achieving an innovation. Technology represents the cumulative *stock* of these innovations. It therefore includes all activities that provide assets with which an economic actor can generate products or services. Science provides us with more generic knowledge, which may or may not generate products and services.

Innovation and technology lie at the core of the greater interdependence that we see as part of globalisation. International business is tightly connected not only because it enables firms and countries to be interdependent (through communication technologies, transportation,

logistics, etc.) but also because it is the source of economic growth and competitiveness (see Chapter 3).

Growth comes from the ability of a nation's industries to develop and sustain their competitive position, and this requires growth in the productivity of its capital and labour. Economic growth concerns not just the acquisition and development of knowledge through innovation and learning, but also the diffusion and efficient utilisation of this knowledge.

New technologies

New technologies are only new until an even newer technology comes along. There have been numerous waves of new technologies, each of which has contributed to an industrial revolution, or, at the very least, to industrial *evolution*. The first industrial revolution was instigated in part by the development of centralised production units (the factory), the mass production of textiles, the use of waterpower and access to cheap cotton (from the colonies). A century or so later, chemical mass production, the internal combustion engine, electricity, the telegraph and the telephone brought about another. Some have argued that information and communications technologies (ICTs) represent a new 'revolution'. Each of the technologies credited has fundamentally affected the organisation of economic activity, and has had knock-on effects on a wide variety of sectors. However, it is not always clear why certain technologies are regarded as more important than others. New technologies constitute a paradigm that shares the distinctive features of creating a technological *discontinuity*, and having significant cross-industry influences.

Each of these new technologies has, in its turn, promoted the increasing interdependence of economic units. Steam power made transportation much more reliable and rapid. Electricity and radio technologies improved communications. That the British managed to maintain an empire as far-

flung as it did owes much to these technological changes: goods could be transported to and from colonies efficiently and cheaply; colonial administrators were able to keep in touch with London; civil unrest was curtailed by the use of machine guns. At the same time, these new technologies have allowed firms to coordinate and control (much more efficiently and reliably) their activities in different countries, and utilise differences in factor costs and inputs to better exploit comparative advantages and scale economies. The boundary-spanning MNE might never have come to exist in the absence of each of these 'new' technologies.

Information and communications technologies are pervasive because they have affected numerous other industries. Biotechnology – another 'new' technology – is highly dependent on advances in automation and data processing. In the absence of ICTs, mapping and cloning genes would be a tedious and slow process. Without these technologies, the human genome project might have taken several times as long. ICTs have affected other products where the importance of data processing and communications was hitherto marginal or negligible, such as the automobile, which was primarily a mechanical product. The average new automobile boasts several microprocessors controlling everything from the positioning of the seats and the anti-lock braking system, to electronic fuel injection and the ignition system. A whole gamut of new industries has evolved where ICTs are a core and central technology: internet service providers, e-bookshops, mobile telephony and global positioning systems, to mention but a few.

ICTs are also a facilitating technology. Satellites, fixed-line networks, mobile networks, the internet and networked computers have all acted to reduce costs of communications while improving reliability, efficiency and coverage. Distances have 'shrunk'.

ICTs also *facilitate* economic activity by disseminating information, collecting information or reducing transaction, information and

communication costs. These developments have had a significant effect on the ability of the MNE to coordinate overseas activities (be they sales or manufacturing subsidiaries), as well as better undertake outsourcing and alliances.

The knowledge-intensive, multi-technology firm

It has long been the case that undertaking any form of economic activity has required access to a variety of skills and knowledge. There is an increasing need for non-traditional and non-intuitive skills. Many of the skills and much of the knowledge required in the workplace today require a certain level of education. 'Basic skills' that one acquired through primary or secondary education are less relevant in today's workplace. Newer technologies have a greater non-intuitive aspect.

Two decades ago, subjects such as 'principles of microprocessor design', 'integrated circuit fabrication' or even 'printed circuit board (PCB) design' were specialist topics in engineering departments, the subject of masters-level and doctoral theses. Today the first two of these are taught in advanced bachelor-level courses, and the last is such a general topic that amateur books teach one all there is to know. Technology matures over time: there is a proportional (but non-linear) decline in its uncertainty and a corresponding increase in its appropriability.

Products and production are increasingly multi-technology in nature. Seemingly independent technologies are required for products and processes, which have hitherto been seen as mono-technology products. This is not an entirely new phenomenon, but its intensity has increased. A car is no longer simply a mechanical engineering product, but requires technological competence in areas as diverse as ceramics, computing, communications and plastics, among others. It is true that there are products and processes which are 'simple' and will probably remain so. However,

most firms need a larger base of knowledge. Multi-technology firms must maintain multiple competences and maintain a minimum level of in-house expertise in several fields in order to monitor externally developed knowledge and integrate it with its other production inputs.

Even where products are mono-technology-based, the processes used to manufacture them often utilise several technologies. The increasing cross-fertilisation of technologies across disciplines and resultant broader portfolio of competences has become fundamental to the competitiveness of technology-based firms. There has also, however, been a concurrent increase in competition, due to the liberalisation of markets, and the reduction of transaction and transportation costs. This has led to a decline in profit margins due to increased cross-border competition. The increased costs of requiring more technology and knowledge across many sectors is not offset by greater profits. R&D in new technologies is increasingly expensive. Reducing costs (and maintaining profits) while maintaining the firm's technological assets has become an important managerial challenge.

SOCIO-POLITICAL DEVELOPMENTS

Economic interdependence is partly driven by political events, and most importantly by political stability. Stability of policies, and the creation and maintenance of the appropriate environment, plays a significant role in promoting the appropriate environment for firms to prosper. First, firms and entrepreneurs need to be able to claim and defend their property rights. Second, they need to be able to establish contracts that are legally enforceable, and to be able to do so at a reasonable cost and within a reasonable timeframe. The World Bank's Doing Business survey estimates the average time it takes to enforce a contract through the law courts, and it is easy to see the considerable differences between countries.

However, it is one thing to be able to enforce a contract within the same country; it is entirely more to enforce contracts across borders. Different legal systems means that a contract signed under one jurisdiction is invalid in another, and being able to enforce an international contract requires nation-states to sign and enforce multilateral and bilateral agreements that allow this to happen. A Dutch firm undertaking a joint venture with a Brazilian company would typically sign three contracts: one under Dutch law, another under Brazilian law, and a third contract under US law, so that disputes could be managed by referring to the English text. This creates costs for both firms, since each needs to retain three legal teams in three different countries.

The ease with which goods and services move between countries can affect the competitiveness of firms that are engaged in international business. This has to do not only with the presence of roads, railways and other transportation links, but also the *institutions* which we will discuss in

the next section. A study by the Inter-American Development Bank found that the various problems in enforcing the regulatory and institutional frameworks between members of Mercosur, a free trade area in Latin America, suffered from a lack of enforcement. A truck carrying goods from Brazil to Chile required 200 hours for a 3,500-km journey, of which 50 per cent is spent at the two border crossings. There is often a lack of common institutions, and a lack of political consensus in maintaining and properly enforcing these.

This leads us into the issue of institutions, a key concept in understanding business and strategy.

WHAT ARE INSTITUTIONS?

In the social sciences, **institutions** are not a synonym for ‘organisations’. Institutions are the ‘sets of common habits, routines, established practices, rules, or laws that regulate the interaction between individuals and groups’.[11] They are the ‘invisible glue’ that holds all economic actors together. Several authors define institutions as being the ‘rules of the game’, but this is an oversimplification. Institutions can be formal and informal. **Formal institutions** are rules that may take the form of legal codes, laws and promulgations, government decrees that are legally laid out and codified. Formal institutions can also exist in the form of rules within a firm. Responsibilities, job descriptions, codes of conduct, and accounting and financial regulations are all forms of formal institutions that are binding upon employees within a firm.

Informal institutions are – by definition – not always laid out in the form of written instruction, but come out of usage and tradition and are often unwritten and tacit. That is, people in that particular environment may ‘know’ these rules, but to outsiders they are unknown, and are often transmitted simply by use. Countries have informal institutions, and some of these are often described as part of the national ‘culture’. However, informal institutions are not entirely the same thing as culture. It is an unwritten rule (an informal institution) to shake hands with men, but not with women in South Asia. Firms also have informal institutions that are defined by interaction. IBM no longer formally requires male staff to dress in dark conservative suits, but should you wear the wrong outfit, you can be sure that someone will let you know that you have contravened an informal institution!

Institutions create the milieu within which economic activity is undertaken and establish the ground rules for interaction between the various actors; they represent a sort of ‘culture’. Institutions will probably have taken years – if not decades – to create and sustain.

Formal institutions can be changed by senior management (the dress code in IBM used to be a formal institution) and by countries when new laws are passed by government, but this does not necessarily change the behaviour of people. There may be a formal law that requires firms not to discriminate on the basis of age or gender, but this does not change the informal institution: there is still a glass ceiling for women in most companies. Habits and routines continue to prevail, often long after the formal institutions have changed. This is known as *institutional inertia*. In general, informal institutions are much harder to change than formal ones. Almost all European countries passed laws that forbade smoking in public spaces 20 years ago, but it took another 10 years before it became socially unacceptable to do so. The informal institutions were eventually modified to match the formal institutions, but it took a long time.

Introducing change in institutions is slow within countries, and within the same company; it is even more complex where the new institutions require synchronisation between countries, or within an MNE that is located in several countries or regions.

Institutions and supranational agreements

Not all formal institutions are national or subnational. Globalisation and the subsequent growth of international business have prompted the need to establish global and regional agreements to monitor and regulate economic activities.

The **World Trade Organization (WTO)** was established on 1 January 1995, and it is now the umbrella organisation that governs the international

trading system. It is the successor to the **General Agreement on Tariffs and Trade (GATT)**. The GATT was established in 1947 to liberalise trade and negotiate trade concessions among member countries. Although the early years saw a great deal of progress in reducing tariffs, by the 1980s there was a trend towards protectionism by many countries. At the GATT's eighth round of negotiations in 1986 (called the Uruguay Round because this is where the group met), negotiations dragged on for years before culminating in a number of agreements including reductions in industrial goods and agricultural subsidies, the increased protection of intellectual property rights under the Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS), the creation of the General Agreement on Trade in Services (GATS), and the creation of the WTO to implement the GATT agreement. Today the WTO is enforcing these agreements. Presently, the Doha Round of the WTO has opened the door for further trade negotiations.

When member nations have a dispute, they can turn to the WTO to help resolve it. For example, the United States brought a case against the EU, charging it with a discriminatory banana import policy and the WTO ruled in its favour. In another case the United States requested that Japan be instructed to reorganise its commercial economy so that Kodak could better compete in that market against Fuji, its major rival, but the WTO rejected the claim and ruled in Japan's favour. In recent years many developing countries (in addition to the developed ones) have been using the WTO to help resolve trade disputes, and this bodes well for the future of the organisation. The important thing to remember about the WTO is that it can enforce its decisions. Countries that refuse to comply can find themselves suffering severe consequences in the form of trade retaliation. Despite minor conflicts, international trade liberalisation has arrived and this promises to help stimulate international business transactions.

In the financial services sector, there are a number of supranational agreements. It is worth highlighting developments connected with the Basel Accords. The Basel Accords refer to the banking supervision Accords – Basel I, Basel II and Basel III – issued by the Basel Committee on Banking Supervision. They provide recommendations on banking regulations connected to capital risk, market risk and operational risk. The purpose of the accords is to ensure that financial institutions have enough capital on account to meet obligations and absorb unexpected losses. From 1988 the Basel I framework was introduced initially in member countries: Belgium, Canada, France, Germany, Italy, Japan, Luxembourg, the Netherlands, Spain, Sweden, Switzerland, the UK and the US. Over 100 other countries have also adopted the principles prescribed under Basel I. Basel II, first published in 2004, introduced risk weighting into the capital requirements for different activities. Basel III is still in its infancy stage, providing a framework on bank capital adequacy, stress testing and market liquidity risk.

Globalisation and liberalisation

The liberalisation of economic systems has been a decisive feature of the post-1945 'liberalisation', and one of the underlying reasons behind the growth of international firms and international business, and the need for supranational organisations. Liberalisation has come to have many meanings, and these include the liberalisation of capital flows, the liberalisation of trade regimes and the liberalisation of markets and economic systems. These are core to understanding globalisation and the growth of interdependence.

International capital flows can be differentiated into several types:[12]

- foreign direct investment;
- international bank lending;

- international bonds and other credit instruments;
- portfolio investment, which implies ownership of shares or bonds of firms located overseas without the control associated with direct investment;
- international equities and other financial instruments (such as options and derivatives);
- development assistance and aid (both government-to-government aid, and NGO-controlled flows);
- monetary flows (through the sales and purchase of foreign currencies).

Liberalisation has also occurred incrementally, but by far the most significant change goes back to the regulations (and organisations to monitor and enforce these regulations) established by the Bretton Woods agreement in 1944. It led to the growth of multinational banking, international money markets, derivatives trading, debt trading, and the cross-border listing and multiple listing of firms on several stock markets, to mention but a few developments. The growth of these new forms of investment has also caused new kinds of economic challenges, including the sub-prime mortgage crisis, and highlighted the need for greater cross-border regulation of MNEs that are able to take advantage of differences between national regulatory frameworks.

The liberalisation of capital flows within the Bretton Woods agreement demonstrates its ideological origins, and reflects certain market capitalism-based value systems and institutions. A large number of countries liberalised capital flows in the mid-1980s, as a means to attract international investment. The increasing globalisation of capital markets has led to considerable loss in economic autonomy of individual governments. The lack of control over domestic economic development has seen the need for governments to pursue policies designed to minimise disruptive financial

flows, and this has pushed most to even greater levels of financial liberalisation and greater engagement in IB.

Liberalisation is an important force in economic globalisation and promotes interdependence of economies. It is implicit within this view that FDI and MNE activity can be undertaken with much greater ease than previously, and the rest of this chapter looks into this in greater detail.

MULTINATIONAL ENTERPRISES

At the core of the twenty-first-century incarnation of globalisation sits the multinational enterprise (MNE) or multinational corporation (MNC). There is good reason to take care in defining the MNE. Richard Caves defined the MNE as a multi-plant firm that controls and coordinates operations in at least two countries.[13] John Dunning focused on certain characteristics that distinguished MNEs from what we might call 'firms with international activity', which is a definition still in popular use.[14] Essentially, this considers an MNE to be one which has substantial ongoing operations in foreign locations through FDI. Until the 1950s, many large MNEs were vertically integrated, which means that they engaged in almost all of the production from raw materials to finished goods within the same firm, and each country unit was largely self-contained. Ford owned rubber plantations in Brazil to manufacture its own tires in the early 1920s. It also invested in its own iron foundries, coal mines, glassworks and railways. Most of these MNEs actively managed their foreign affiliates, and these affiliates were subsidiary to the parent firm, by which we mean they were highly dependent upon the parent firm for all major decisions. The foreign affiliate was actively managed by the parent, and in general, the affiliate did what it was told to do. Knowledge flowed primarily in one direction, from the parent to the subsidiaries.

Until the 1990s, FDI and MNE activity were considered synonymous because managing and coordinating a subsidiary across borders (in countries with different legal systems) and enforcing contracts across distances was considered difficult (and costly) to achieve. Thus ownership was considered to be the preferable option, rather than utilising the market to transact with

non-affiliated foreign actors. Most international and national agencies that maintain and collect data on MNE activity still generally define the MNE as a firm that *owns* and *controls* value-adding operations in more than one country.[15] However, globalisation has played a significant role in changing the need to own assets in order to control them: as we shall discuss later in this chapter, and in Chapter 2, firms can engage in control with limited or no ownership.

Although FDI is one of the main modes by which MNEs engage in cross-border value-adding activities, today the MNE may also control and engage in value-adding activities through non-equity means, such as through strategic alliances, cooperative agreements, and outsourcing, sometimes without *legal* ownership of the various factories and plants, but *de facto* controlling the operations of the non-legally affiliated operation (see Chapter 2). Therefore, the use of the term 'MNE' as a synonym for FDI is increasingly inaccurate.[16] MNEs can and do organise activities through global production networks (GPNs) and global value chains (GVCs), and manage ongoing and systematic vertical transactions through multiple headquarters, which may or may not be associated with a singular 'parent company'.

The MNE has traditionally also been regarded as having a distinct 'home country' where its headquarters are located, and which acts as the command centre, providing primary strategic direction for its affiliates in various 'host countries', as well as providing the primary or core assets on which the affiliates base their operations. Indeed, the home country establishment is referred to as the 'parent firm', implying that the home country is at the top of a hierarchy of affiliates or subsidiaries. Furthermore, residents of the home country are assumed to own (and therefore control) the international operations of the MNE.

Although most MNEs are still organised along these lines, there are a growing number of firms where ownership and control are spread across several countries, as well as several cases where an MNE may locate its headquarters in a country other than its home country. Its stock may be traded on multiple stock exchanges in several countries. South African Breweries (SAB) is a South African-based MNE that is the historical 'parent' of SABMiller, one of the world's largest brewers by volume, with more than 200 brands and brewing interests and distribution agreements in 80 countries across six continents. Employing more than 70,000 global staff members, SABMiller has its primary listing on the London Stock Exchange, and for legal purposes is a UK firm. However, its senior management, strategic decision making, and organisational culture remain very much South African.[17] SABMiller itself announced at the end of 2015[18] that it was to be acquired by its larger rival Anheuser-Busch InBev, which is also the result of a merger of Ambev, a Brazilian brewer, Interbrew, a Belgian-based firm, and Anheuser-Busch, a US brewer (and while Anheuser-Busch InBev is traded on the Brussels and the New York Stock Exchange, its management is dominated by its Brazilian partners, even though its corporate headquarters are in Belgium). The US$107 billion merger between SABMiller and Anheuser-Busch InBev represents one of the world's largest acquisitions ever made, raising some concerns from the federal antitrust authorities.[19] In 2016, the combined company controlled 28 per cent of the global market and had a 45 per cent US market share. It is also an illustration of MNEs that have multiple headquarters located in different countries, with strategic control distributed along geographic, product, or functional lines. Another example of such an MNE is Unilever which has its corporate headquarters in London, UK and Rotterdam, NL.

The nature, structure and organisation of the MNE has changed quite considerably, and this change has been exacerbated by developments

associated with the globalisation of products, markets and services, as well as political and economic developments associated with shifting political hegemonies and economic liberalisation. Thus, a more accurate and current definition of an MNE is: *a firm that engages in value-added international business activities, that has affiliates in more than one country, and whose operations and activities in different locations are actively coordinated by one or more headquarters organisations*. Emphasis is placed on the presence of interdependencies between the various economic units in different locations, and their active coordination and control across borders, and not on the ownership structure.

Despite the importance given to MNEs, they do not account for a dominant or even a major share of the world's economic activity. In terms of employment, the world's largest MNEs employed 75 million *directly* in 2014, up from about 20 million in 2000. Despite this steady increase, MNCs account for only 2 per cent of global employment (as of 2017). In terms of indirect effects – that is, people employed in firms that engage with MNEs, either as suppliers or through strategic alliances, or other partnerships – the figure is probably closer to 200 million. Put into context, with a world working population of about 3 billion, the direct number represented only 2.5 per cent of total global employment, and the total number including direct and indirect employment is possibly no higher than 6 per cent. Despite the relatively small role of MNEs on an aggregate level, however, the situation differs substantially across countries. MNEs account for less than 5 per cent of the total employment in countries such as Japan and Indonesia, but this figure rises to well over 40 per cent in countries such as Malaysia, Argentina and Ireland. The significance of MNEs in terms of sales, value adding and ownership of assets is of similar magnitude.

However, two characteristics of the operations of MNEs stand out. First, larger MNEs have been found to be concentrated in the more 'dynamic'

sectors of the economy. Thus, even though they play a relatively small role in most economies in terms of the level of total employment, MNEs often play a disproportionately large role in two different types of industrial sectors. They tend to be most active in sectors typified by high growth rates, rapid innovation, and the use of new and emerging technologies (e.g., electronics, communication equipment and industrial machinery), and also in mature sectors where economies of scale, branding, and advertising determine market share (e.g., petroleum products, chemicals, automobiles, food and beverages, and consumer goods). In mature sectors, while the technology underlying these industries may be diffused and codified, growing scale economies can result in a global oligopoly of a few MNEs maintaining a large share of the global market. A good example is the petroleum sector.

In general, a majority of MNEs come from developed-economy home countries. As we shall discuss later in this chapter, while the emerging economies are increasingly playing a greater role, it remains restricted to a handful of countries. These trends reflect the strong positive correlation between the level of economic development and the growth of firms from these economies that have the technological and organisational capabilities to compete globally with the more established MNEs in world markets.[20]

How do MNEs contribute to employment? The Economic Commission for Latin America and the Caribbean (ECLAC) suggests that it varies significantly by country and sector.[21] In the Caribbean, when investment targets the tourism sector, it estimated that each US$1 million of investment generated about six jobs, while the same investment in the financial sector, and mining and natural resource-intensive manufacturing, generated fewer than two jobs.[22] In Mexico and Central America, where the focus was on manufacturing, US$1 million generated four jobs on average. In South

America, where investment tends to be linked to natural resources, the average number of jobs estimated to be created by $1 million was 2.5.

Proto-globalisation and the MNE in historical context

Although the term 'globalisation' has recently been coined, the growing interdependence between countries and their firms is not new. All the constituent provinces of the Roman Empire shared a common set of laws and enforcement mechanisms. Tariff rates on trade were standardised, and they enjoyed the benefits of a common currency, a well-maintained transport infrastructure, and the financial and security apparatus to ensure safe conduct of these activities. Imports came from as far away as India and China to meet the demand for spices and silk,[23] while salt and leather came from West Africa. The Arabs and the Somalis were crucial in transporting these imports by sea and across the Sahara, while innumerable diplomatic treaties with neighbouring states created the stability for these goods and services to be transported. Financial payment systems through moneylenders (who maintained an informal network with each other) allowed traders to travel without large amounts of gold and silver. These kinds of linkages and networks operated in a number of other large empires in the past two millennia, including the Parthians and the Ottoman, Malian, Austro-Hungarian, Spanish, and British empires.

Much of the IB activity was dominated by market transactions, with a flow of goods between locations in response to supply and demand. There was no systematic interaction between producers in country A and customers in country B. Such trading activities do not necessarily result in a high degree of interdependence. Raw materials were transported from one location to another, manufactured, and transported to other locations to be sold. However, while there was significant movement of goods, and to some extent also of labour through immigration, most economic actors were

immobile, and did not, as a rule, have operations in more than one location (until the last 100 years or so). That is, although financial capital was moved as individuals lent money to others in other locations, contracts were made between individuals in different locations; these were financial flows and flows of goods rather than a movement of physical assets or personnel. There was no significant integration of operations in different locations within the control and management of the same individuals. The idea of a 'firm' as we understand it did not exist; rather these were most often entrepreneurs and family members, without an ongoing business enterprise that involved any sort of active coordination. These early 'firms' were *international*, but not *multinational*. International business and economic activity was *extensive* in the sense that the value of goods and capital exchanged was considerable, and sometimes involved numerous countries and actors.[24] But it was not *intensive*, in that activities were largely not integrated across borders.

It was only later, somewhere in the late 1500s, that large trading companies and other state-sanctioned *de facto* monopolies such as the British or French East and West India companies came into being, and these were the first MNEs. Sea travel and international trade were hazardous and costly, and required considerable resources, and such ventures required widespread risk sharing. However, such firms were far and few between. Even as late as the 1780s, large firms were the exception rather than the rule in Europe and elsewhere – there were few firms with more than 30 employees.[25]

Although the economies of Asia during the 1700s accounted for 60 per cent of the world's GDP, compared with about 25 per cent for Europe,[26] the weakness of individual property rights and the feudal political structures[27] meant that most economic activity was similarly concentrated in the hands of the state or state-sanctioned actors, while much of private enterprise was

small-scale, and international trade and cross-border flows of goods, services and capital were small and sporadic.[28] Although data are scarce, there was considerably more trade between Europe and China and India than there was between China and India.

The industrial revolutions and the growth of private firms

The first industrial revolution (starting with the discovery of steam power, which in turn led to the growth of railways, steam-driven manufacturing and powered ships), in conjunction with a number of important social and political developments, unleashed a period of rapid growth in Europe.[29] The economies of Europe expanded rapidly from the mid-1700s, leading to a consequent expansion and proliferation of firms in the modern sense – organisations with a recognisable structure, property rights and ownership, engaged in ongoing, systematic and regular economic transactions. This was also supported by the growth of stock markets, insurers and banks that helped to reduce the risk to the individual entrepreneur. The legal and institutional setting also helped establish property rights and legal structures that permitted their growth. Two main consequences of this growth helped drive globalisation further. First, there was a shortage of raw materials, and an international expansion to secure new supplies of inputs. Second, there was a shrinking of demand for 'traditional' handmade products, which were more costly than factory-produced manufactures.

Parallel advances in transportation – especially shipping, and related fields such as map making, clocks and astronomy – made transcontinental trade more reliable and subsequently cheaper. From the early 1800s, international trade grew by around 3.5 per cent per annum for the rest of the century.[30] The British, Dutch and French East India companies vied with each other to supply foreign markets with manufactured goods, as well as to acquire imports of raw materials.

The benefits of the new industrial technologies of steam power and automated mass manufacturing combined with declining transportation costs had the effect of displacing local manufacturing activities in Asia, South America and Africa with imports from Europe. These new technologies also rapidly diffused to other countries, especially North America, which also sought overseas markets and cheaper raw materials, while raising tariffs on imported (European) goods. The adoption of the Gold Standard, which fixed the value of national currencies to the price of gold, reduced foreign exchange risks. A second industrial revolution helped cement the gains from the first industrial revolution, from the 1870s till the early 1900s. New important discoveries included telephony, telegraphy, electricity, a rapid expansion of railways, improved steel production, the internal combustion engine, and large-scale chemical production.

By 1913 most of the industrialised nations had become part of global capital markets. By the late 1800s the GDP of India and China had shrunk by about half of their pre-industrial revolution levels. Japan, on the other hand, had taken advantage of the new industries and by the early part of the twentieth century had become an industrialised nation (not, as many suppose, after World War II).

Assisted by the growing support infrastructure in finance, and the declining risks of investing abroad, private firms and entrepreneurs in the mid-1800s also began to make cross-border investments. European banking houses began opening up specialist facilities in the colonies to finance and support foreign investment.[31] For obvious reasons, opportunities were greatest in the new colonies and investors began to erect factories abroad. Many of these were what are known as ‘free-standing companies’. Typically, they were legally incorporated in their home country. They usually specialised in a single commodity, product or service, often in a single overseas country. As discussed earlier, one of the primary characteristics of

the MNE is that control is exercised from head offices at ‘home’. These were among the earliest private MNEs, although it is a matter of some debate to what degree these were established by residents of the ‘host’ with a foreign passport and no apparent organisational link to a ‘parent’ company at ‘home’. During the 1800s a considerable amount of foreign investment in the European colonies abroad was carried out by free-standing companies.

Nevertheless, the first true multinational firms which were systematically coordinated and controlled by a parent firm in the home country came about around this time. Although this was initially an issue of natural resources, firms like Siemens and IG Farben from Germany, and Singer and Bell from the US, began expanding manufacturing activities abroad. By 1914, multinational manufacturing was also undertaken in a wide range of manufactured products, such as chemicals, pharmaceuticals, automobiles and food products. These MNEs witnessed a continuous flow of knowledge and other resources across borders within the boundaries of firms.

FOREIGN DIRECT INVESTMENT

As discussed in the previous section, the first 'modern' MNEs with coordinated activities that were controlled and systematically managed by parent firms began to emerge from about the late 1870s. By the 1900s, it became necessary to distinguish between foreign investment and foreign 'direct' investment. The term 'direct' is intended to indicate that this did not involve merely a movement of capital, as might be the case with 'portfolio' investments in shares, stocks and other financial instruments, which are sometimes referred to as 'foreign portfolio investments'. Foreign direct investment (FDI), in contrast, represented investments which provided the owners with not just ownership, but through that ownership, strategic and managerial control of an ongoing enterprise.

Measuring FDI and MNE activity

FDI has – since the 1950s – been the primary means by which governments, researchers and supranational organisations have measured the level and intensity of MNE activity. This is because FDI is a measure that is readily available. All countries in the world are obliged to keep (and publish) records of long-term capital flows as a requirement by the International Monetary Fund and World Bank, and these are published as part of their balance of payments data. These data measure *flows* of FDI. Countries keep a record of monies that have been identified as being FDI, and this is recorded separately from portfolio capital transfers. *Inward FDI* flows to country A indicate money coming into country A during the reporting year, from foreign-owned MNEs to their subsidiaries in country A. In this case, country A is known as the *host country*. *Outward FDI* flows are monies

going out, from firms that are registered in country A (known as the *home country*) to their subsidiaries in other countries.

Flows measure new money coming in or going out, and serve an important purpose for the IMF and central banks in working out the gross national product (GNP) and other statistical indicators of the amount of economic activity taking place in a country. It is also possible to estimate the growth of economic activity by MNEs (both outgoing and incoming). However, this does not tell us very much about *ongoing* economic activity. To take an example, suppose IBM built a large office in Tokyo in 1950, and this investment cost $50 million, which IBM transferred from the US to Japan in that year. As a result of this investment, it generated sales in Japan of $10 million a year, for the next 10 years. Let us suppose that IBM used the profits from these sales of $1 million a year to expand its operations by *reinvested earnings*. In other words, by 1960, the value of its investment was $60 million. If we relied on the flow data, we would only be able to see that IBM had FDI flows in 1950, and none thereafter, and we might wrongly conclude that there had been no increase in its activities in Japan or in its employment.

FDI stock data, on the other hand, are supposed to give us a more reliable estimate of the significance of MNE activity, and form a more reliable indicator of its contribution to the economy. MNEs might also build up their subsidiary by borrowing money locally. FDI stock allows us to estimate – more reliably – the sales and value-adding activity done by MNEs. However, FDI stock data are not completely reliable either, because they underestimate old investments. IBM's building in downtown Tokyo might be worth $1 billion by 2000, but you would not be able to estimate this from the flow data (assume there were no other inflows from IBM in the US to Japan) because the data from 1950 to 2000 would only record a zero for each year. The stock data would indicate $100 million (assuming an annual reinvested

earning of $1 million). Reinvested earnings are not the only item missing: firms may raise capital locally from the sale of bonds, or from local loans. Nevertheless, FDI stock data (if properly and diligently calculated) give a more accurate idea of the contribution an MNE makes to the host economy, and have a monotonic relationship to its local value-adding activities. FDI stock also provides a better measure of how this significance changes over time, and by taking into account previous investments, it allows us to compare the relative importance of MNEs between countries.

Where FDI stocks are not available, international agencies such as UNCTAD estimate stocks by taking an accumulation of flows for a certain number of years as a rough proxy. Although such estimations are not always perfect, they still provide a better estimate of changing trends in the value of MNE activities than flow data.

Throughout this book we will try to refer to stock data wherever available, because they allow a fairer comparison between countries.

MNEs before World War II

Data from the early 1900s are hard to come by, but estimates suggest that about one-third of the US$40–50 billion in foreign investment in 1914 was FDI. As Figure 1.3 shows, the major source of FDI stocks in 1914 was Britain, which accounted for 45 per cent of the total, while western Europe as a region accounted for more than 80 per cent of all FDI stock. Latin America and Asia were especially important as host economies, even though the largest individual host countries were the US and Canada.

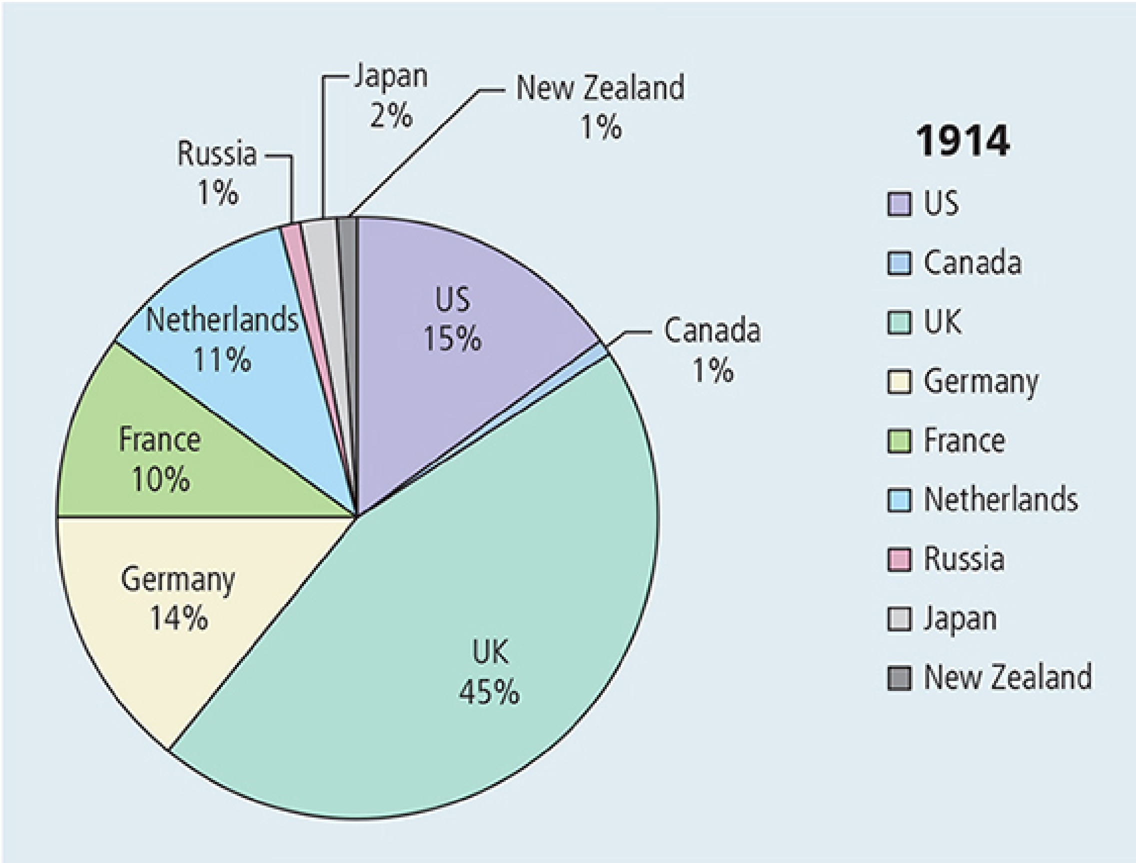

Figure 1.3 Estimated stock of outward FDI by country of origin, 1914

Source: Adapted from J. H. Dunning, *Multinational Enterprises and the Global Economy* (Wokingham: Addison Wesley, 1993).

Over 55 per cent of the FDI in 1914 was directed to the primary sector, 20 per cent to railroads and only about 15 per cent to manufacturing activities. Manufacturing investments were mainly concentrated in Europe, the US and the UK colonies, but this was the era of large plantations (such as sugar, rubber, tea, coffee, cocoa, cotton, palm oil and beef). These operations engaged in minimal local processing and were vertically integrated suppliers to parent firms that manufactured final products for consumers in the developed world. Vertical integration reduced the uncertainties of markets, while ensuring captive inputs. A number of major MNEs from that era are still major players in international business: firms like Shell, BP, Exxon,

Unilever, Philips, Nestlé, Ford, Tata, Jardine Matheson, HSBC, BASF and Agfa.

The rise of the modern MNE

In general, the early twentieth century showed the signs of a burgeoning economic interdependence between countries, and early cross-border interdependence between firms, both within countries and between countries. Although international trade is not new, the beginning of the twentieth century saw an important change to international business with the growth of FDI and the multinational corporation.

Still further fundamental changes began to appear. The first firms began to *internationalise* – and by this we mean these ‘proto-MNEs’ were interested in developing vertical linkages that led to a flow of goods through trade between locations, in response to varying elasticities of supply and demand. Later, this led to some degree of processing and coordination. Raw materials were transported from one location to another, manufactured, and transported to a third location for sale. These were the first *multinational enterprises* because they were not simply moving capital from one location to another to increase their returns. They were utilising proprietary knowledge, knowledge capital embodied in physical assets or personnel, knowledge of markets, or expertise as efficient managers that allowed them to make significant and regular returns on their investments. There was also increasing (and later, significant) integration of operations in disparate locations within the control and management of the same individuals.

Such early multinationals became more and more commonplace, and, as the twentieth century progressed, more manufacturing MNEs that did more than just facilitate trade began to appear. Early manufacturing MNEs included Ford, Singer and IG Farben.

The way in which international business was conducted was helped extraordinarily by new technological advances associated with the second industrial revolution. Goods – both final goods for consumers and raw materials – could be easily transported over long distances by the expanding network of fast and cost-effective railways and shipping lines from and to almost all parts of the world, and within countries. The invention of the internal combustion engine, petroleum refining and the automobile helped further, especially with the transportation and logistics within countries. Electricity and its distribution proliferated, outmoding steam power, but providing an even cheaper basis for mass production and vast new arrays of products and services that did not exist before. Production systems that created efficiencies for large-scale plants that allowed bulk chemicals to be synthesised cheaply led to growing vertically integrated operations and scale economies. Telegraph and telephones drastically improved the efficiency with which people could communicate across the world. This made possible mass production and mass marketing for the first time, allowing firms to take advantage of markets, while also increasing their need for raw materials from elsewhere.

Perhaps most importantly, the combination of a growing financial services industry and the availability of international sources of finance (manufacturing industries are by definition capital-intensive) and greater efficiencies of scale and efficiencies of scope led to the growth of large firms, and with it, the growth of professional management.[32] The era of the large firm naturally led to the era of the large MNE. One of the key developments was managerial – instead of owner-managers, the development of large corporations came out of the evolution of a new type of firm that was administered by a hierarchy of salaried professional managers.

The world economy became increasingly unstable from 1914. There was a severe recession in Europe soon after the end of World War I in 1918, and the US Great Depression in 1929 caused a worldwide economic shock. US GDP fell by almost a third between 1929 and 1933. Declining primary commodity prices caused sharp falls in real incomes for the producer countries in Latin America, Asia, Africa and Australia. The Russian Revolution was followed by the sequestration of foreign-owned assets by the Soviet Union.

Political and economic nationalism was increasingly common in developing countries that were independent, such as in Latin America. They began to question foreign control and ownership over their natural resources and their dependence on imports for manufactured goods. Import substitution came to be seen as an important means to reduce their economic dependence on MNEs. A number of countries used tariffs, import quotas and other trade barriers to help infant industries and foster their manufacturing sectors by import substitution. At the same time, dictatorships ruled Germany, Italy and Japan, and foreign investments were either 'pushed out', or were nationalised. Figure 1.4 gives data on FDI trends and patterns for 1938, and it is apparent that changes were marginal during this period: the dominance of Europe and particularly the UK as a source of FDI remained unchallenged, although the growth of US FDI and the decline in the importance of Germany as a source of FDI are also noticeable.

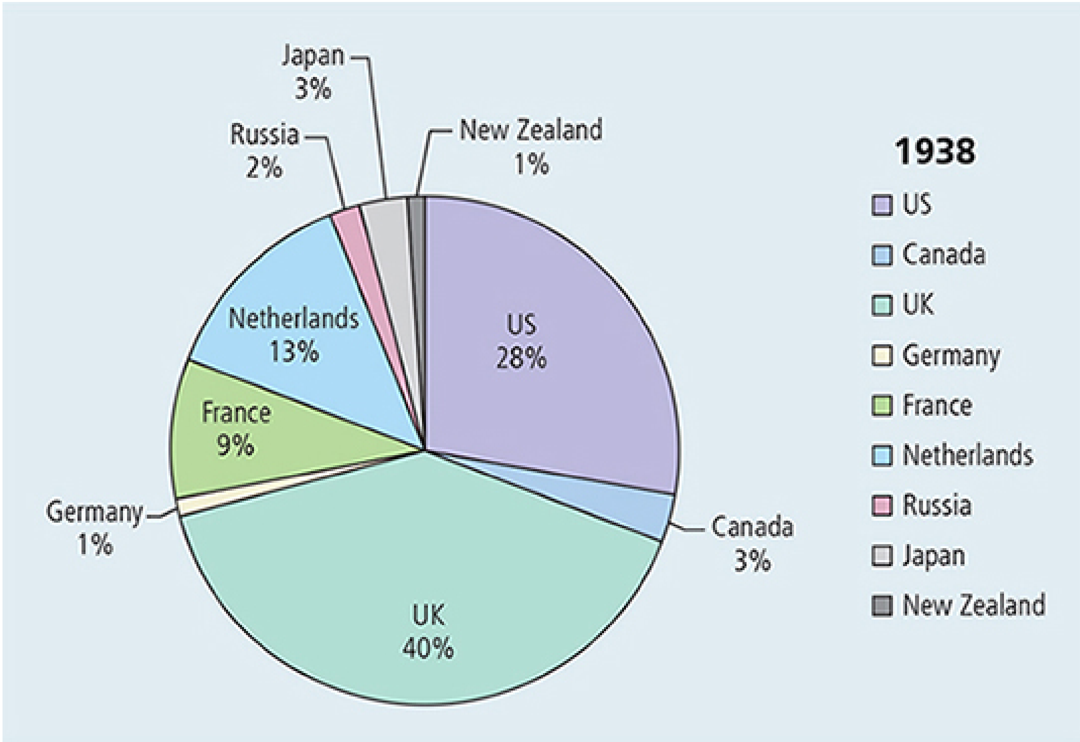

Figure 1.4 **Estimated stock of accumulated FDI by country of origin, 1938**

Source: Adapted from J. H. Dunning, *Multinational Enterprises and the Global Economy* (Wokingham: Addison Wesley, 1993).

INTERNATIONAL BUSINESS IN THE MODERN ERA

World War II (1939–45) represents a watershed in political, social and economic terms, and can be taken to be a turning point in globalisation. To be clear, it was not the physical and human losses as much as the outcomes from its aftermath that have shaped the world economy indelibly. On a political level, after 1945, the world economy was dominated by the US; the geopolitical stage was set through an East–West ideological divide between the two military superpowers, the United States and the USSR, and their spheres of influence. The reconstruction of Europe and Japan after the war was shaped by the US, and equally importantly, by the establishment of US-centric economic policies and economic systems that encouraged international trade and investment. The Bretton Woods agreement established a standardised economic system, payment systems and regulatory mechanisms, along with organisations such as the World Bank and the International Monetary Fund. The first round of the General Agreement on Tariffs and Trade, signed by 23 countries, was a multilateral agreement that helped regulate international trade. In other words, many countries adopted similar formal institutions (at both a national and supranational level) that created a mechanism to engage in higher levels of trade (but not for FDI).

The various European colonial possessions in Asia, Africa and Latin America became independent between 1945 and 1960, all seeking to become more economically prosperous and to engage in the global economy to varying extents. China came out of its civil war by 1949 as a unified country, but chose to close its economy almost completely.

1950–90: the rise of the triad

During the 1950s, the world economy was dominated by the United States, which accounted for about 50 per cent of the world's output and almost 80 per cent of the FDI stock. The US dollar became the world's major reserve currency. US MNEs assumed leading positions in many industries. Much of the infrastructure of Europe and Japan had been destroyed, and the production facilities of these firms badly damaged, and they spent the first decade of the post-war era undergoing extensive reconstruction, heavily dependent on official aid from the United States. Many of the leading firms from Europe and Japan had either lost their foreign assets through war reparations, or sold them. Most of these countries had exchange controls which limited international capital movements and restricted their international expansion in any case.

By the early 1960s, there had been rapid growth in these economies, reflected in the growing competitiveness of their exports and increasing expansion of their MNEs. The developed countries accounted for 97 per cent of the total global outward FDI stock in 1967, of which the US accounted for 57 per cent. The majority of inward FDI stocks – 73 per cent – were directed to other developed countries, while the largest host developing region was Latin America and the Caribbean with 18.5 per cent. The most highly involved home countries of MNEs in Europe were Britain and the Netherlands, with 16 and 11 per cent respectively.

By the early 1980s, the pace of globalisation had further intensified. The influence of the United States had diminished somewhat, as wealth was more equally distributed between the triad countries of North America, Europe and Japan, which accounted for around three-quarters of world manufacturing production. The domination of the triad is evident by the fact

that even by 1990, the share of inward FDI to developed countries was 76.8 per cent (Table 1.2).

In terms of host developing regions, the most important host regions were in Asia and Latin America. Even by 1990, China and India were largely unimportant as host countries, accounting for just 1 per cent of the world total.

1990–2017: the rise of new players and forms of activity

During the 1990s, the pace of globalisation intensified. National restrictions over cross-border capital flows were largely swept away as financial deregulation spread. The most striking changes were in emerging markets.

Some argue that China's move towards greater integration in the world economy was the beginning of this shift (officially, market-oriented policies were first introduced in 1979); others feel that the collapse of Communism in Russia and eastern Europe in the late-1980s was the turning point. Yet others point to Europe, where this was the beginning of important institutional changes, with the members of the European Economic Community (EEC) working hard towards the introduction of a Single European Market (SEM) in 1992. Negotiations for the North American Free Trade Agreement (NAFTA) were moving towards completion by 1994, but started much earlier. A number of other regional integration schemes also began around this time, including the Mercosur customs union inaugurated by Brazil, Paraguay, Uruguay and Argentina in 1995. The Association of Southeast Asian Nations (ASEAN), which had started as largely a political effort to create cohesion in the region, set the basis for a degree of regional integration.

Not coincidentally, there was also a process of economic and financial liberalisation in Africa, Asia and Latin America, which led to widespread deregulation and privatisation, and opened further opportunities.

Negotiations for the Uruguay Round of GATT were also being undertaken concurrently, beginning in 1986 and completed in 1984. The Uruguay Round expanded GATT to include services, capital, intellectual property and agriculture. It was the first set of multilateral trade negotiations in which developing countries played an active role.

With hindsight, it seems amazing that there were so many key socio-political and economic turning points across the world coming to a head at about the same time. It is difficult to be precise about causes and effects, but there is little doubt that these events were contemporaneous.

The situation was almost certainly helped by new technological paradigms in transportation (the growth of containerisation, improved air transport), and ICTs, which made it cheaper and faster to communicate across countries, and to conduct cross-border financial transactions. The advent of the internet played an important role in creating new markets, reduced coordination and search costs, and made it easier to enforce informal contracts.

New industries came about as a result of both these technologies and the new markets that opened up to international business. These included tourism, telecommunications, media services, software, banking, agriculture, utilities and real estate. Many services sectors, which had long been closed to foreign investment and were often limited by law to domestic actors, grew rapidly: 63 per cent of the total global inward FDI stock by 2012 was in the services sector, up from less than 10 per cent in 1990. New technologies reduced the barriers to new, smaller firms entering these industries, which had in the past been restricted to a handful of large firms.

Modularisation, outsourcing and value chains

From the 1990s, there was also a relocation of labour-intensive industry functions from rich countries to lower-wage countries with skilled

workforces. This followed a new tendency to 'fine-slice' activities so that they could be modularised, thereby taking advantage of cheaper inputs wherever they might be. Back-office processing, call centres, accounting and software maintenance and development all became growth industries for countries such as India, the Philippines, Egypt, Mauritius, Pakistan, South Africa and others.

Modularising products and services has led to a considerable geographic reorientation of the world economy. Outsourcing and the use of complex *global value chains* (GVCs) and *global production networks* (GPNs) has been especially important for the growth of international investment in the developing countries. In the case of manufacturing, the benefits of this expansion have been most keenly felt by the Asian economies, especially China, Korea, Taiwan, Malaysia and Thailand.

Global value chains have played a large role in the expansion of retail and trading MNEs. Tesco, a British retail giant with operations in 12 countries, relies on complex webs of suppliers from around the world to ensure that it is able to sell its customers grapes sourced from India, tomatoes from Spain, and avocados from South Africa, all delivered at competitive prices and fresh, whether in the UK, Thailand or Korea. Tesco is able to take advantage of its size by ordering in bulk and ensuring through the careful use of logistics and shipping that these perishable products are delivered fresh to its customers.

The continuing importance of the state-owned enterprise

The growth of commodities trade in developing countries (both agricultural and extractive) has been spurred by the privatisation of state-owned enterprises (SOEs) in the countries that have liberalised their economies, and the rapid growth of the world economy from the mid-1990s to about 2013

has been fuelled by high prices on traditional commodities, and subsequently the growth of MNEs in these areas.

While some countries privatised SOEs, they continued to flourish in other countries including China. Much of the growth in new MNEs from emerging markets reflects the growth of China. While the number of Chinese firms entering the Global Fortune 500 tripled between 2010 and 2014, the evidence suggests that few of them are truly internationalised. Indeed, the majority of the 73 large Chinese firms are SOEs and they have most of their total sales within China. They are still largely in the protected banking, insurance, natural resources, utilities, telecommunication, land and real estate and development, engineering and construction industries. Even where SOEs have been privatised, governments continue to exert considerable influence on their activities.

Many developing economies had nurtured SOEs and national champions as part of their economic and industrial policies since the 1950s, and these continue to be important – Brazil has Petrobras, Malaysia has PETRONAS, India has Indian Oil. They often also provided protection against competition, and subsidised their outward expansion. Although various agreements within the WTO (combined with economic liberalisation) have led to the dissolution or at least weakening of such state support, this has provided them with the initial impetus to internationalise.

Emerging economy MNEs – significant but exaggerated

Although there is considerable hype about the growth of emerging country MNEs (EMNEs), the hard evidence is less impressive. Not all foreign investment is necessarily a foreign *direct* investment. Investments from developing countries may represent an institutional investment through a private equity firm, a sovereign wealth fund, or a portfolio investment. This is the case in many of the acquisitions by oil-exporting countries (including

the Middle East countries, but also Russia) and China, where individuals or (state-owned or state-influenced) firms have access to capital, and acquire ownership in companies which gives them the *potential* to exert control, although in many cases they do not do so.

The acquisition of a dominant share in a foreign-based enterprise may be undertaken because it provides superior oversight and reduces the costs of shirking compared to non-equity modes of cooperation or a minority equity share. Thus firms may overvalue the benefits of having a dominant, majority or wholly-owned foreign affiliate, because the investor's home country does not provide it the experience of trusting other modes of entry share. Such investments are *de jure* FDI, but *de facto* portfolio investments.

Nonetheless, there is sufficient MNE activity from developing countries that is worthy of note. Although the growth of the Chinese economy over the last 25 years marks the single most important shift of economic power in the new global economy, the significance of the 'four tigers', or Asian newly industrialised countries (NICs) – Hong Kong, Singapore, South Korea and Taiwan – should not be underestimated. These four countries grew rapidly from the mid-1960s, and in terms of intensity of engagement with the world economy, and they are arguably more important in international business than China or India. Taiwan and Korea are deeply integrated in the global value chains of the electronics sector, while Singapore and Hong Kong are deeply linked within the transportation, finance and logistics industries. Taiwan is the home country of Hon Hai/Foxconn, arguably the world's largest MNE with over a million employees. Indeed, in terms of income levels, all four countries are at a similar level of development to most of Europe and North America.

Table 1.1 gives the data of outward FDI stock for the NICs. They accounted for just 2.3 per cent of the stock in 1990, but by 2017 this share

had increased to 10.8 per cent, significantly more than the BRICS, which consist of Brazil, Russia, India, China and South Africa.

A number of studies point to the rapid growth of developing country FDI stocks. As a percentage of total outward stock this increased from 6.2 per cent to 22.3 per cent between 1990 and 2017. However, these data are misleading and do not indicate a broad phenomenon, but one that is limited to just a few countries. These data are summarised in Figure 1.5. Excluding the BRICS countries and the Asian NICs, we see only a slight increase in the outward FDI stock from developing countries as a share of total world FDI stock, from 1.2 per cent to 3.7 per cent over the period (which, given that these are nominal data, represents a real decrease). These data suggest that much of the growth in outward MNE activity from 'developing countries' comes from a group of nine countries, some of which (the NICs) are to all intents and purposes developed countries, and have been so since the beginning of the new millennium. Indeed, the continued inclusion of the Asian NICs in the classification of developing countries seems somewhat strange and even problematic, given that on a GDP per capita basis (whether real or nominal) they have clearly converged with the developed world.

Table 1.1 FDI outward stock by countries (millions of US$), 1980–2017

Country	1980		1990		2000		2010		2017	
	Value	% of total	Value	% of total	Value	% of total	Value	% of total	Value	% of total
World	**548,198**	**100.00**	**2,253,944**	**100.00**	**7,298,188**	**100.00**	**20,414,081**	**100.00**	**30,837,927**	**100.00**
Developed economies[a]	**477,203**	**87.0**	**2,114,508**	**93.8**	**6,535,722**	**89.6**	**16,978,445**	**83.2**	**23,498,002**	**76.1**
North America	239,158	43.6	816,569	36.2	2,931,653	40.2	5,446,299	26.7	9,287,061	30.1
United States	215,375	39.3	731,762	32.5	2,694,014	36.9	4,809,587	23.6	7,799,045	25.3
Canada	23,783	4.3	84,807	3.8	237,639	3.3	636,712	3.1	1,487,130	4.8
Germany	43,127	7.9	308,736	13.7	541,866	7.4	1,463,065	7.2	1,607,380	5.2
United Kingdom	80,434	14.7	229,307	10.2	923,367	12.7	1,635,791	8.0	1,531,683	5.0
Netherlands	41,867	7.6	109,870	4.9	305,461	4.2	1,004,454	4.9	1,604,884	5.2
Other developed economies[a, b]	*24,612*	*4.5*	*244,556*	*10.9*	*388,640*	*5.3*	*1,367,441*	*6.7*	*2,103,322*	*6.8*
Australia	4,983	0.9	37,505	1.7	92,508	1.3	449,740	2.2	460,641	1.5
Japan	19,612	3.6	201,441	8.9	278,442	3.8	831,076	4.1	1,519,983	4.9
Developing economies[a]	**70,995**	**13.0**	**139,436**	**6.2**	**762,065**	**10.4**	**3,400,014**	**16.7**	**6,898,384**	**22.3**
Asian NICs	*14,056*	*2.6*	*52,386*	*2.3*	*524,192*	*7.2*	*1,737,423*	*8.50*	*3,322,862*	*10.8*
Hong Kong	148	0.0	11,920	0.5	379,285	5.2	943,938	4.6	1,804,249	5.8
Singapore	772	0.1	7,808	0.3	56,755	0.8	458,650	2.2	841,402	2.7
South Korea	127	0.0	2,301	0.1	21,497	0.3	144,032	0.7	355,758	1.1
Taiwan	13,009	2.4	30,356	1.3	66,655	0.9	190,803	0.9	321,453	1.0
Developing economies minus Asian NICs	*56,939*	*10.4*	*87,050*	*3.9*	*237,873*	*3.3*	*1,662,591*	*8.1*	*3,575,522*	*11.6*
BRICs	*44,164*	*8.1*	*60,633*	*2.7*	*128,917*	*1.8*	*1,055,010*	*5.2*	*2,648,841*	*8.5*
Brazil	38,545	7.0	41,044	1.8	51,946	0.7	191,349	0.9	358,915	1.2
China	0	0.0	4,455	0.2	27,768	0.4	317,211	1.6	1,482,020	4.8
India	78	0.0	124	0.0	1,733	0.0	96,901	0.5	155,341	0.5
Russia	n/a	–	n/a	–	20,141	0.3	366,301	1.8	382,278	1.2
South Africa	5,541	1.0	15,010	0.7	27,328	0.4	83,249	0.4	270,287	0.9
Developing economies minus BRICs	*26,831*	*4.9*	*78,803*	*3.5*	*633,149*	*8.7*	*2,345,004*	*11.5*	*4,249,543*	*13.8*
Developing economies minus Asian NICs and BRICs	*12,775*	*2.3*	*26,417*	*1.2*	*108,956*	*1.5*	*607,581*	*3.0*	*926,681*	*3.0*
Tax havens	**72**	**0.0**	**1,525**	**0.1**	**88,052**	**1.2**	**613,732**	**3.0**	**1,361,971**	**4.4**
British Virgin Islands	0	0.0	875	0.0	67,132	0.9	334,406	1.6	879,716	2.8
Mauritius	0	0.0	1	0.0	132	0.0	864	0.0	824	0.0
Cayman Island	72	0.0	648	0.0	20,788	0.3	88,062	0.4	235,155	0.8
Panama	-	-	0	0.0	0	0.0	3,374	0.0	4,855	0.0
Luxembourg	0	0.0	0	0.0	0	0.0	187,027	0.9	241,421	0.8
Transition economies[c]	**0**	**0.0**	**0**	**0.0**	**400**	**0.0**	**35,623**	**0.2**	**441,541**	**1.4**

Notes:

[a] The values for 'developed economies' represent the sum of all countries included in the UNCTAD's classification; the countries listed are just a sample of the population.

[b] According to UNCTAD's classification, other developed economies include Australia, Bermuda, Israel, Japan and New Zealand.

[c] Although UNCTAD classifies Russia as a transition economy, we have included Russia's outward FDI stock at the developing economies' values.

Source: Created by the author based on data taken from UNCTAD (1980–2017).

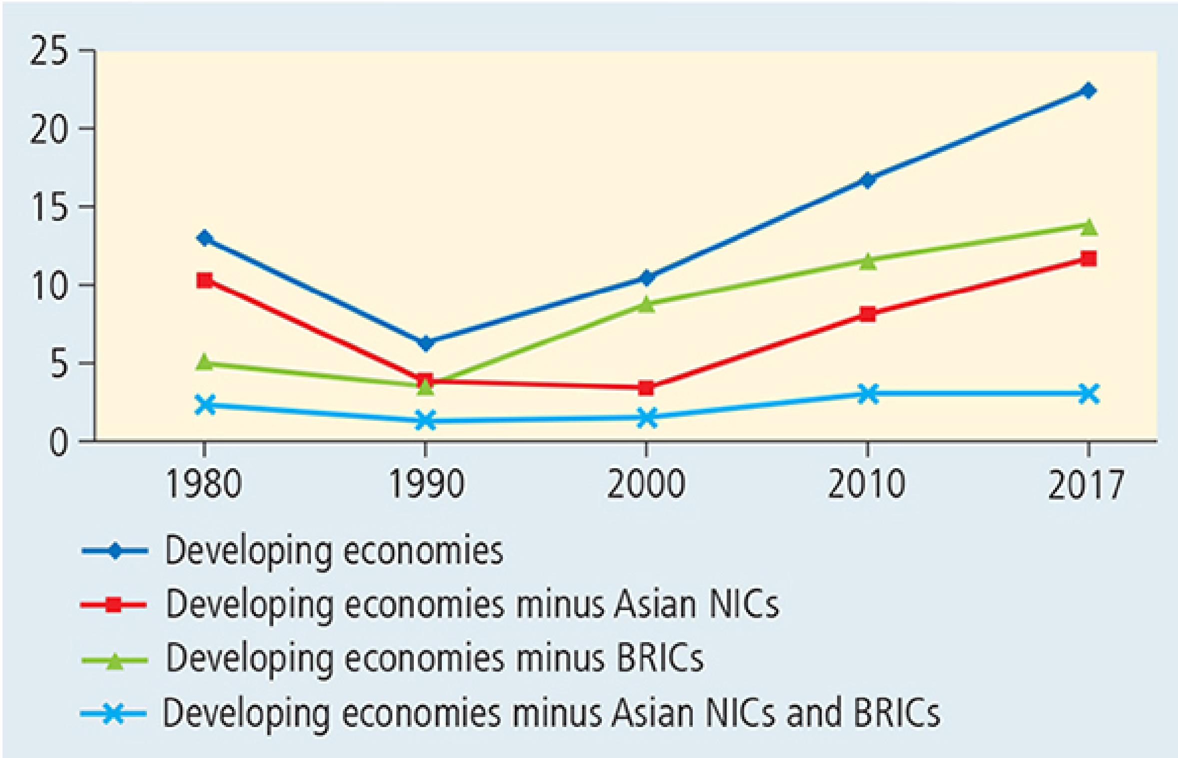

Figure 1.5 FDI outward stock from selected developing economies as a percentage of the world's FDI outward stock

Source: Created by author, data taken from UNCTADSTAT.

Tables 1.1 and 1.2 also give data for offshore tax havens. In general, the use of these tax havens distorts the data. Some of these tax havens are ostensibly large outward investors, as well as large recipients of inward FDI. The British Virgin Islands inward FDI stock was $661 billion in 2017, higher than Russia or India, and close to that of Australia. Many of these funds move out equally fast – outflows from the British Virgin Islands were $70 billion and outward stock was $879 billion in 2017. Other tax havens include Mauritius, the Cayman Islands, Panama and Luxembourg. Despite their heterogeneity, all these countries act as offshore investment hubs for MNEs. They tend to have low taxes and few legal requirements governing their activities. These operations are most often subsidiaries (and headquarters) 'based' in these countries, which are 'letterbox' companies

with a legal address, but no local activities and little accountability. Such tax haven operations typically have FDI flows coming in, with the money subsequently leaving as outflows to third countries. Google achieved an effective tax rate of 2.4 per cent on its non-United States profits in 2009 by routing profits to Bermuda. There is also round-trip investing, where FDI flows come in from a source country, and return to the same country. Information is understandably hard to obtain on these activities, but one of the largest inward investors to India is Mauritius, which is also a major destination for Indian outward FDI. This way, Indian firms move money abroad, and then take it back to India, where it is given tax and investment benefits normally reserved for foreign investors. In other words, significant investment in offshore financial centres means that outward FDI data may not accurately reflect reality.

Dominance of the triad continues

Table 1.3 gives us a sense of the significance and internationalisation of the world's largest MNEs, and those coming from emerging markets. On average, these new MNEs have internationalised their sales and employment, but in terms of assets, they remain concentrated at home. Compared to the triad MNEs, however, they are on average much smaller, and considerably less internationalised.

Table 1.2 FDI inward stock by countries (millions of US$), 1980–2017

Country	1980		1990		2000		2010		2017	
	Value	% of total	Value	% of total	Value	% of total	Value	% of total	Value	% of total
World	**697,913**	**100.0**	**2,197,768**	**100.0**	**7,202,348**	**100.0**	**19,607,406**	**100.0**	**31,524,356**	**100.0**
Developed economies[a]	**401,633**	**57.5**	**1,687,652**	**76.8**	**5,476,613**	**76.0**	**12,789,150**	**65.2**	**20,331,171**	**64.5**
North America	137,209	19.7	652,444	29.7	2,995,951	41.6	4,014,166	20.5	8893757	28.2
United States	83,046	11.9	539,601	24.6	2,783,235	38.6	3,422,293	17.5	7,807,032	24.8
Canada	54,163	7.8	112,843	5.1	212,716	3.0	591,873	3.0	1,084,409	3.4
Germany	36,630	5.2	226,552	10.3	271,613	3.8	716,704	3.7	931,285	3.0
United Kingdom	63,014	9.0	203,905	9.3	463,134	6.4	1,094,833	5.6	1,563,867	4.9
Netherlands	19,168	2.7	71,828	3.3	243,733	3.4	647,723	3.3	974,706	3.1
Other developed economies[a, b]	*349,660*	*50.1*	*102,629*	*4.7*	*217,655*	*3.0*	*864,824*	*4.4*	*1,077,326*	*3.4*
Australia	24,776	3.6	80,364	3.7	121,686	1.7	527,064	2.7	662,296	2.1
Japan	3,270	0.5	9,850	0.4	50,322	0.7	214,880	1.1	207,488	0.7
Developing economies[a]	**296,280**	**42.5**	**510,107**	**23.2**	**1,702,016**	**23.6**	**6,579,217**	**33.6**	**10353481**	**32.8**
Asian NICs	*186,650*	*26.7*	*247,042*	*11.2*	*609,227*	*8.5*	*1,898,763*	*9.7*	*3,570,991*	*11.3*
Hong Kong	177,755	25.5	201,653	9.2	435,417	6.0	1,067,520	5.4	1,968,645	6.2
Singapore	5,351	0.8	30,468	1.4	110,570	1.5	632,766	3.2	1,284,929	4.1
South Korea	1,139	0.2	5,186	0.2	43,738	0.6	135,500	0.7	230,597	0.7
Taiwan	2,405	0.3	9,735	0.4	19,502	0.3	62,977	0.3	86,820	0.2
Developing economies minus Asian NICs	*109,630*	*15.7*	*263,066*	*12.0*	*1,092,788*	*15.2*	*4,680,454*	*23.9*	*6,782,490*	*21.5*
BRICs	*35,465*	*5.1*	*68,701*	*3.1*	*407,592*	*5.7*	*2,145,868*	*10.9*	*3,243,461*	*10.3*
Brazil	17,480	2.5	37,143	1.7	122,250	1.7	682,346	3.5	778,287	2.5
China	1,074	0.2	20,691	0.9	193,348	2.7	587,817	3.0	1,490,933	4.7
India	452	0.1	1,657	0.1	16,339	0.2	205,580	1.0	377,683	1.2
Russia	n/a	–	n/a	–	32,204	0.4	490,560	2.5	446,595	1.4
South Africa	16,459	2.4	9,210	0.4	43,451	0.6	179,565	0.9	149,962	0.5
Developing economies minus BRICs	*260,815*	*37.4*	*441,406*	*20.1*	*1,294,423*	*18.0*	*4,433,349*	*22.6*	*7,110,020*	*22.6*
Developing economies minus Asian NICs and BRICs	*74,165*	*10.6*	*194,365*	*8.8*	*685,196*	*9.5*	*2,534,587*	*12.9*	*3,539,029*	*11.2*
Tax havens	**249**	**0.0**	**4,318**	**0.2**	**65,136**	**0.9**	**567,937**	**2.9**	**1,269,233**	**4.0**
British Virgin Islands	1	0.0	126	0.0	32,093	0.4	236,858	1.2	661,718	2.1
Mauritius	26	0.0	168	0.0	683	0.0	4,658	0.0	5,122	0.0
Cayman Islands	222	0.0	1,749	0.1	25,585	0.4	133,421	0.7	374,171	1.2
Panama	–	–	2,275	0.1	6,775	0.1	20,742	0.1	50,174	0.2
Luxembourg	0	0.0	0	0.0	0.0	0.0	172,257	0.9	178,048	0.7
Transition economies[c]	**0**	**0.0**	**9**	**0.0**	**23,720**	**0.3**	**239,040**	**1.2**	**839,704**	**2.7**

Notes:

[a] The values for 'developed economies' represent the sum of all countries included in the UNCTAD's classification; the countries listed are just a sample of the population.

[b] According to UNCTAD's classification, other developed economies include Australia, Bermuda, Israel, Japan and New Zealand.

[c] Although UNCTAD classifies Russia as a transition economy, we have included Russia's outward FDI stock at the developing economies' values.

Source: Created by the author based on data taken from UNCTAD (1980–2017).

Table 1.3 Internationalisation statistics of the 100 largest non-financial MNEs worldwide and from developing and transition economies (billions of US$, thousands of employees and %)

	100 largest MNEs worldwide			100 largest MNEs from developing and transition economies		
	2016	2017	2016-2017 % change	2015	2016	% change
Assets						
Foreign	8,337	9,004	8.0	1,716	1,886	9.9
Domestic	4,894	5,491	12.2	4,289	4,511	5.2
Total	13,231	14,495	9.6	6,004	6,397	6.5
Foreign as % of total	63	62	−1.4	29	29	0.9
Sales						
Foreign	4,765	5,170	8.5	1,734	1,559	−10.1
Domestic	2,737	2,793	2.1	1,903	1,965	3.3
Total	7,502	7,964	6.2	3,638	3,524	−3.1
Foreign as % of total	64	65	2.2	48	44	−3.4
Employment						
Foreign	9,535	9,757	2.3	4,003	4,603	15.0
Domestic	6,920	6,889	−0.4	7,900	7,434	−5.9
Total	16,455	16,646	1.2	11,903	12,038	1.1
Foreign as % of total	58	59	1.2	34	38	4.6

Source: Adapted from UNCTAD. *World Investment Report*, 2018, Table 1.7 (p. 29).

The data for 2017 in Tables 1.1 and 1.2 is quite revealing. The triad countries still play a significant role in absolute terms, with the US alone accounting for 25.3 per cent of all outward FDI stock, which is more than the UK, Canada, Germany and the Netherlands put together. Despite the rapid growth in flows from China, without including Hong Kong it has a stock value equal to Canada, and not much larger than Singapore. India and South Africa show a similar, relatively low level of outward FDI stock.

In terms of inward FDI, the story is similar. China's share of inward FDI stock has continued to rise, but is still about a quarter of that in the US, and only slightly more than Singapore.

Small and medium-sized enterprises

Whenever MNEs are discussed, it is common to hear about large firms. In fact, the best-known multinationals are companies that have become household words. Everyone knows of Honda, Unilever, Google, and Volkswagen. However, there are hundreds of thousands of **small and medium-sized enterprises (SMEs)**, many of which are suppliers to these

MNEs.[33] Most of these companies have annual sales of less than $5 million, but they are able to compete effectively and perform functions that multinationals cannot do as efficiently. They are especially important in the global era because the improved enforceability of contracts and declining transaction and monitoring costs resulting from globalisation have made it easier for SMEs to engage in international business.

Since SMEs are small operations they are much more flexible in a variety of ways, and they are invaluable partners to larger firms because they can change direction, focus and structure with relative ease. One of the major competitive advantages SMEs have over large firms is their flexibility. Larger firms wishing to outsource for various reasons tend to rely on SMEs because they are especially astute in utilising external networks more efficiently.[34] SMEs overcome their biggest disadvantage – limited resources – by the skilful use of alliances.[35] SMEs also overcome their limited size and resources by being more innovative than larger firms in the same industry. SMEs have tended to have an innovation advantage in highly innovative industries where the use of skilled labour is relatively important.

Although SMEs have the advantages of being flexible and responding rapidly to change, there are also disadvantages due to their absolute size limitations. Nonetheless, SMEs are the backbone of many industries because of their efficiency and flexibility. In this book, we will be studying a large number of international business concepts that are used not just by large MNEs but also by smaller MNEs.

Part of the reason for the proliferation of smaller firms in developing countries is that inefficient regulations and poorly functioning institutions discourage entrepreneurs from entering the formal sector. The Indian manufacturing sector is dominated by microenterprises, of which the overwhelming majority are in the informal sector, and their productivity is half that of larger enterprises.[36] While small firms in India have achieved

higher growth rates than larger firms in recent years, they also have a labour intensity that is almost four times higher than large enterprises.[37] The dominance of the informal sector is a result of India's labour legislation and pre-reform regulations that, on the one hand, provide special incentives to microenterprises by limiting the entry of larger firms in certain sectors, while on the other hand, limiting the ability of larger firms to lay off or replace workers, or declare bankruptcy. Firms, therefore, prefer to be capital-intensive rather than labour-intensive to avoid the complexities of becoming larger. Large firms also tend to fragment outsourced activities to a considerable number of small units (perhaps because the smaller firms predominate), creating further inefficiencies.

There is some evidence that SMEs are more innovative than their larger counterparts. According to the US Small Business Administration (US-SBA), firms of fewer than 500 employees in the United States represent 99.7 per cent of all firms and employ just over half of all private sector employees.

Studying smaller international firms provides a useful contrast to large multinational firms. In particular, comparisons reveal the importance of scale and scope as sources of certain kinds of competitive advantages for internationalisation, as outlined by Alfred Chandler.[38] Small firms have neither the manpower nor the financial resources to spread their options geographically or make many mistakes when they take their first steps into new markets. This means that they have to be particularly entrepreneurial, innovative and adaptive when expanding abroad.[39]

The fragmented firm: global value chains and production networks

As we have discussed, control and coordination can be achieved through a minority ownership, and in some cases through non-equity means.

Historically, FDI and MNE activities have been synonymous, partly a reflection of the way in which most international and national agencies maintain and collect data on MNE activity. Although FDI remains one of the main modes by which MNEs engage in cross-border value-adding activities, the MNE may also control and engage in value-adding activities through non-equity means, such as through cooperative agreements and outsourcing, sometimes without *de jure* ownership of the productive assets, but *de facto* controlling the operations of the non-affiliated operation. Therefore, the use of the term 'MNE' as a synonym for FDI is increasingly inaccurate.[40] We emphasised in our definition of the MNE the interdependencies between the various operations in different locations, and their active coordination and control across borders, rather than the ownership structure. One of the powerful effects of globalisation is that there is a shift away from traditional hierarchies towards a richer variety of organisational modes (see Chapter 2 for a discussion of entry modes). This has occurred along with a systematic shift in certain sectors and a variety of industries away from the vertically integrated firm. Globalisation has made it easier for firms of all sizes to monitor, identify and establish collaborative ventures than had previously been the case. In other words, hierarchical control and full internalisation are no longer always a first-best option for MNEs.

International production and trade are increasingly organised within **global value chains** (GVCs) or **global production networks** (GPNs) where the different stages of the production process are located across different countries. Globalisation motivates companies to restructure their operations internationally through outsourcing and offshoring of activities. GVCs can be 'producer-driven' or 'buyer-driven' chains.[41] Producer-driven GVCs are more common in high-tech sectors such as pharmaceuticals. Lead or 'flagship' firms are upstream and control the design of products, while the assembly is fragmented in different countries. In buyer-driven chains,

retailers control the production taking place in other countries, but focus on marketing and sales. Such GVCs are common in the apparel and food and agriculture industries.

GVCs are typically coordinated by MNEs, with cross-border trade of inputs and outputs taking place within their networks of affiliates, contractual partners, and arm's-length suppliers. MNE-coordinated GVCs account for some 80 per cent of global trade. MNEs coordinate GVCs through complex webs of supplier relationships and various governance modes, from direct ownership of foreign affiliates to contractual relationships (in non-equity modes of international production), to arm's-length dealings.[42]

The spread of GVCs is greater in industries where activities can be more easily separated and modularised, such as electronics, automotive and garments, but GVCs increasingly involve activities across all sectors, including services. The majority of developing countries participate in GVCs. However, many poorer developing countries are still struggling to gain access to GVCs beyond natural resource exports.

Non-equity modes (NEMs) involve no FDI whatsoever (see Chapter 2 for a discussion on modes). The controlling MNE has no ownership stake, while maintaining a level of control over the operation by contractually specifying the way it is to be conducted. Outsourcing arrangements within a GVC most often require some degree of coordination by the MNE or lead firm of the outsourcing company. The defining features of NEMs – coordination and control of independent firms through contractual and non-contractual means, with a material impact on the conduct of their business – can blur the rigid distinction between FDI, NEMs and trade.[43]

Nestlé has at least 600,000 contract farmers in over 80 developing economies as direct suppliers of various agricultural commodities. Similarly, in the electronics and automotive industries, contract manufacturing is very

important, with firms typically outsourcing more than 50 per cent of production by cost of goods sold. In the electronics sector, a small number of contract manufacturers dominate the industry and produce for all major brands in the industry. By far the largest contract manufacturer is Taiwan's Hon Hai Precision Industry, which owns Foxconn. With an annual turnover of US$154.7 billion and a market capitalisation of US$49 billion, it had net profits of US$4.6 billion in 2017.

The top developing country locations for outsourcing services (managed both by major developed country players and by local firms) are still in Asia. Three countries – India, the Philippines and China – accounted for around 65 per cent of global export revenues related to information technology/back-office processing services, partly because of locational advantages such as language and IT skills, the low cost of labour, and ICT infrastructure. However, the industry is expanding to countries such as Argentina, Brazil, Chile, the Czech Republic, Egypt, Morocco and South Africa. UNCTAD estimates that worldwide, some 18 to 21 million workers are directly employed in firms operating under NEM partnership arrangements in selected industries and value chains.

This fragmentation of value chains has not happened in all industries and sectors, or even in all aspects of value added. For instance, the degree of outsourcing and NEM in R&D remains very low. In general, equity solutions such as FDI may provide the firm with greater control over foreign operations, reducing the risk of technology loss to suppliers and competitors, especially when the competitive advantage is based on easy-to-copy technology.[44] Some products and services are harder to modularise, and require large amounts of effort to reintegrate them. This may be because, in order to outsource, you need to invest heavily in codifying your knowledge, and this cost may also be prohibitive. Lastly, it is important that multiple

alternative suppliers exist for what you want to outsource – where the firm becomes dependent upon one supplier, it can create a hostage situation.[45]

Indeed, because of all the challenges of outsourcing, firms often prefer to undertake *strategic alliances*.[46] We will discuss strategic alliances in some detail in the next chapter and in Chapter 8.

OUTSOURCING, OFFSHORING AND NEARSHORING

The rapid growth and popularity of global networks and global value chains is linked to the phenomena of outsourcing and offshoring. For international firms, the need to focus their resources on value-creation activities and to have a considerable level of flexibility to respond to external shocks has forced them to make decisions about whether they should perform a certain value-added activity themselves or outsource it to another entity.

Traditionally, *outsourcing* was done by manufacturing firms that, rather than having a fully vertically integrated supply chain, would have some or all of the parts and components of their products manufactured by someone else and do the assembly of the final product themselves. For example, Toyota produces less than 30 per cent of the value of cars that roll off its assembly lines. The remaining 70 per cent mainly accounted for by component parts and complex subassemblies, comes from independent suppliers. In recent years, outsourcing has gone beyond manufacturing activities and spread into the other functions of Porter's value chain (R&D, logistics, HR, etc.). Furthermore, it has also been adopted among service activities. For example, many firms, from credit card issuers to IT service providers, have outsourced their customer call centres.

When the outsourcing is done to a location beyond the national borders it is called *offshoring*. Offshoring can be done internally by moving activities from a parent company to its foreign affiliates (sometimes referred to as *captive offshoring*, involving FDI), or outsourced to third parties offshore in other countries. Decisions over offshoring are largely driven by differences in production cost, taking into consideration transportation costs for both

inputs and outputs, and the need to coordinate between units based in different locations.

In recent years we have witnessed an increasing trend in *nearshoring*. The concept of nearshoring refers to relocation (offshoring) to a nearby country. For example, a UK firm moving its call centres to Ireland instead of India. Some of the driving forces behind the rise of nearshoring include:

- lower transportation costs;
- smaller time zone differences;
- time-to-market; and
- lesser liability of foreignness.

Table 1.4 highlights the advantages of both in-house and outsourcing/offshoring decisions. Clearly there are trade-offs in both internalising and outsourcing decisions.

The decision about which activities should be outsourced and where they should be outsourced to is a firm-specific solution dependent on the firm-specific competitive advantages and the firm's competitive environment. It's about finding the right balance for your company. Hence, it is a decision about *rightsourcing* and *rightshoring*.

Table 1.4 Advantages of in-house operations and outsourcing/offshoring

Internalised (in-house) operations	Externalised (outsourced/offshored) operations
Efficiencies based on internal capability Investment in specialised assets Protects intellectual property Quality control Customer proximity	Cost efficiencies Strategic flexibility Access to external resources Customer proximity

KEY POINTS

1 There is little doubt that we live in a world defined by globalisation. Globalisation, however, remains a vague concept, used by different people in different ways. This book defines economic globalisation as the growing interdependence of locations and economic actors across countries and regions.

2 International business is the study of transactions taking place across national borders for the purpose of satisfying the needs of individuals and organisations. Two of the most common types of international business activity are export/import and foreign direct investment (FDI). In recent years both have been on the rise. Much of this is a result of large multinational enterprises (MNEs).

3 Small and medium-sized enterprises (SMEs) often function as the backbone of large MNEs, efficiently providing goods and services that are integrated into the latter's production process. SMEs also compete with MNEs in niche markets. SMEs are often more flexible then MNEs but struggle to match MNEs in terms of resources.

4 Institutions are defined as 'sets of common habits, routines, established practices, rules, or laws that regulate the interaction between individuals and groups'. Understanding institutions, both formal and informal, is important for both firms and employees, so they can adjust their behaviours accordingly.

5 Trade regulation has become an important issue in international business. Today, the World Trade Organization (WTO) is the major

supranational body responsible for governing the international trading system.

6 There are two ways to measure FDI: FDI stock and FDI flow. Inward FDI flow is money coming into a country during the reporting year, from foreign-owned MNEs which have their subsidiaries in the recipient county. Outward FDI flows are monies going out from firms that are registered in the home country to another country through their subsidiaries abroad. FDI flow is different from FDI stock: the latter looks at the accumulation of FDI over time, whereas FDI flow only looks at FDI inflow or outflow in one reporting year. FDI stock is a more reliable indicator of FDI activity in countries.

7 International production and trade are increasingly organised within global value chains (GVCs) of global production networks (GPNs) where the different stages of the production process are located across different countries. Due to the globalised nature of some markets, it is advantageous for firms to develop products in different countries to benefit from home countries' location advantages.

Key terms

- **international business**
- **exports**
- **imports**
- **international trade**
- **multinational enterprise (MNE)**
- **economic globalisation**

- **interdependence**
- **foreign direct investment (FDI)**
- **upstream and downstream**
- **institutions**
- **formal institutions**
- **informal institutions**
- **World Trade Organization (WTO)**
- **General Agreement on Tariffs and Trade (GATT)**
- **small and medium-sized enterprises (SMEs)**
- **global value chains**
- **global production networks**

NOTES

1 http://www.fasttrack.co.uk/company_profile/codex/

2 M. Strong, 'Developed countries admire role of SMEs in Taiwan: Tsai', *Taiwan News* (2017). https://www.taiwannews.com.tw/en/news/3323721

3 R. Narula, *Globalization and Technology: Interdependence, Innovation Systems and Industrial Policy* (Cambridge: Polity Press, 2003).

4 P. Jenkins and M. Arnold, 'HSBC speeds up exit from emerging markets', *Financial Times* (2015); J. Treanor, 'HSBC to rebrand UK high street bank as global shakeup sheds 25,000 jobs.' *The Guardian* (2015). https://www.theguardian.com/business/2015/jun/09/hsbc-cuts-25000-jobs-globally

5 P. McClean, 'After Brexit: the UK will need to renegotiate at least 759 treaties', *The Financial Times* (2017). https://www.ft.com/content/f1435a8e-372b-11e7-bce4-9023f8c0fd2e

6 G. R. Benito and R. Narula, 'States and firms on the periphery: the challenges of a globalising world.' In G. R. Benito and R. Narula (eds.), *Multinationals on the Periphery* (Basingstoke: Palgrave Macmillan, 2007).

7 J. R. Markusen and A. J. Venables, 'Foreign direct investment as a catalyst for industrial development', *European Economic Review*, vol. 43, no. 2 (1999), pp. 335–56; R. Narula and J. H. Dunning, 'Multinational enterprises, development and globalization: some clarifications and a research agenda', *Oxford Development Studies*, vol. 38, no. 3 (2010), pp. 263–87. Narula, Rajneesh, and Pineli, André, 'Improving the developmental impact of multinational enterprises:

Policy and research challenges', *Journal of Industrial and Business Economics*, vol. 46, no. 1 (2019), pp. 1–24.

8 Although, at the time of writing (January 2019), the UK was still in negotiations with the European Commission to agree on an orderly exit from the EU, the negotiations to conclude the nature of the new relationship are proving difficult to determine.

9 http://ec.europa.eu/eurostat/statistics-explained/index.php/International_trade_in_goods

10 R. Narula, *Globalization and Technology: Interdependence, Innovation Systems and Industrial Policy* (New York: John Wiley & Sons, 2014).

11 B. Gregersen and B. Johnson, 'Learning economies, innovation systems and European integration', *Regional Studies*, vol. 31, no. 5 (1997), pp. 479–90.

12 D. Held, *Global Transformations: Politics, Economics and Culture* (Stanford, CA: Stanford University Press, 2007).

13 R. E. Caves, *Multinational Enterprise and Economic Analysis* (Cambridge: Cambridge University Press, 1996).

14 J. H. Dunning, 'The eclectic paradigm of international production: a restatement and some possible extensions', *Journal of International Business Studies* (1988), pp. 1–31.

15 J. H. Dunning, 'Trade, location of economic activity and the multinational enterprise: a search for an eclectic approach.' In P. J. Buckley and P. Ghauri (eds.), *The Internationalization of the Firm* (London: Thomson, 1999), pp. 61–79.

16 M. Wilkins, 'The history of multinational enterprise.' In A. Rugman and T. Brewer (eds.), *The Oxford Handbook of International Business* (Oxford: Oxford University Press, 2010), pp. 3–35.

17 H. Barnard, 'Migrating multinationals and the theory of the multinational.' In R. Ramamurti and A. Cuervo-Cazurra (eds.),

Understanding Multinationals from Emerging Markets (Cambridge: Cambridge University Press, 2014), pp. 195–223.

18 A. Wexler, 'SABMiller to keep South African listing, allays investors' fears', *Wall Street Journal*, 2015. Access: http://www.wsj.com/articles/sabmillers-potential-sale-rattles-south-african-investors-1444214073

19 B. Pease 'A Big Merger May Flatten America's Beer Market', *The New York Times* (2016). https://www.nytimes.com/2016/06/02/opinion/a-big-merger-may-flatten-americas-beer-market.html

20 UNCTAD, *World Investment Report*, 2006.

21 Economic Commission for Latin America and the Caribbean, *Foreign Direct Investment in Latin America and the Caribbean, 2012* (Santiago, Chile: ECLAC, 2013).

22 Ibid.

23 E. H. Warmington, *The Commerce between the Roman Empire and India* (Cambridge: Cambridge University Press, 1974).

24 D. Held, *Global Transformations: Politics, Economics and Culture* (Stanford, CA: Stanford University Press, 1999).

25 F. Braudel, *The Perspective of the World: Civilization and Capitalism 15th–18th Century*, Vol. 3 (Berkeley, CA: University of California Press, 1992), p. 443.

26 A. Maddison, *The World Economy*, Vol. 1: *A Millennial Perspective*; Vol. 2: *Historical Statistics* (India: OECD, 2007).

27 F. Fukuyama, *The Origins of Political Order: From Prehuman Times to the French Revolution* (New York: Profile Books, 2011).

28 D. S. Landes, *The Wealth and Poverty of Nations: Why Some Are So Rich and Some So Poor* (New York and London: W. W. Norton & Co. 1999).

29 D. S. Landes, *The Unbound Prometheus: Technological Change and Industrial Development in Western Europe from 1750 to the Present* (Cambridge: Cambridge University Press, 2003).

30 G. Jones, *Multinationals and Global Capitalism* (Oxford: Oxford University Press, 2005).

31 Ibid.

32 J. H. Dunning, *Multinational Enterprises and the Global Economy* (Wokingham: Addison Wesley, 1993).

33 UNCTAD, *World Investment Report*, 2015, chapter 5.

34 Also see Paul Ellis and Anthony Pecotich, ‘Social factors influencing export initiation in small and medium-sized enterprises’, *Journal of Marketing Research* (February 2001), pp. 119–30.

35 R. Rothwell and M. Dodgson, ‘Innovation and size of firm.’ In M. Dodgson and R. Rothwell (eds.), *The Handbook of Industrial Innovation* (Aldershot: Edward Elgar, 1994).

36 R. Narula, ‘R&D collaboration by SMEs: new opportunities and limitations in the face of globalisation’, *Technovation*, vol. 24, no. 2 (2004), pp. 153–61.

37 S. M. Dougherty, R. Herd, and T. Chalaux, ‘What is holding back productivity growth in India? Recent micro evidence’, *OECD Journal: Economic Studies*, vol. 1 (2009), pp. 1–22.

38 R. Narula, ‘The viability of sustained growth by India’s MNEs: India’s dual economy and constraints from location assets,’ *Management International Review*, 55 (2015), pp. 191–205.

39 G. A. Knight and D. Kim, ‘International business competence and the contemporary firm’, *Journal of International Business Studies*, vol. 40, no. 2 (2009), pp. 255–73; G. A. Knight, ‘Entrepreneurship and strategy in the international SME’, *Journal of International Management*, vol. 7 (2001), pp. 155–71; S. C. Collinson, *Small and Successful in Japan: A*

Study of 30 British Firms in the World's Most Competitive Market (London: Avebury Press, 1996).

40 R. Narula and J. H. Dunning, 'Multinational enterprises, development and globalization: some clarifications and a research agenda', *Oxford Development Studies*, vol. 38, no. 3 (2010), pp. 263–87.

41 K. De Backer and S. Miroudot, 'Mapping global value chains', *OECD Trade Policy Papers*, no. 159 (Paris: OECD Publishing).

42 UNCTAD, *World Investment Report*, 2013.

43 UNCTAD, *World Investment Report*, 2011.

44 R. Narula and J. Hagedoorn, 'Innovating through strategic alliances: moving towards international partnerships and contractual agreements', *Technovation*, vol. 19, no. 5 (1998), pp. 283–94.

45 R. Narula, 'Choosing between internal and non-internal R&D activities: some technological and economic factors', *Technology Analysis and Strategic Management*, vol. 13, no. 3 (2001), pp. 365–87.

46 R. Narula and A. Martinez-Noya, 'International R&D alliances by firms: origins and development.' In Daniele Archibugi and Andrea Filippetti (eds.), *The Handbook of Global Science, Technology, and Innovation* (Hoboken, NJ: Wiley-Blackwell, 2015).

BIBLIOGRAPHY

Boddewyn, Jean J., Toyne, Brian and Martinez, Zaida L. 'The meanings of "international management"', *Management International Review*, vol. 44, no. 2 (2004).

Cavusgil, S. Tamer and Knight, Gary. 'The born global firm: an entrepreneurial and capabilities perspective on early and rapid internationalization', *Journal of International Business Studies*, vol. 46, no. 1 (2015).

Collinson, Simon and Rugman, Alan, M. 'Case selection biases in management research: implications for international business studies', *European Journal of International Management*, vol. 4, no. 5 (2010).

Dicken, Peter. *Global Shift*, 6th ed. (London: Sage, 2011).

Driffield, Nigel, Jones, Chris and Crotty, Jo. 'International business research and risky investments, an analysis of FDI in conflict zones', *International Business Review*, vol. 22, no. 1 (2013).

Dunning, John H. 'The study of international business: a plea for a more interdisciplinary approach', *Journal of International Business Studies*, vol. 20, no. 3 (1989).

Forsgren, Mats and Yamin, Mo. 'A commentary on Adam Smith and international business', *Multinational Business Review*, vol. 18, no. 1 (2010).

Fruin, W. Mark. 'Bringing the world (back) into international business', *Journal of International Business Studies*, vol. 38, no. 2 (2007).

Gao, Gerald Yong, Danny Tan Wang and Yi Che. 'Impact of historical conflict on FDI location and performance: Japanese investment in China', *Journal of International Business Studies,* vol. 49, no. 8 (2018).

Ghemawat, Pankaj. ‘Distance still matters: the hard reality of global expansion’, *Harvard Business Review*, vol. 79, no. 8 (September 2001).

Ghemawat, Pankaj. *Redefining Global Strategy: Crossing Borders in a World Where Differences Still Matter* (Cambridge, MA: Harvard Business School Press, 2007).

Girod, Stéphane J. G. and Rugman, Alan M. ‘Regional business networks and the multinational retail sector’, *Long Range Planning*, vol. 38, no. 4 (2005).

Hennart, Jean-François, ‘Down with MNE-centric theories! Market entry and expansion as the bundling of MNE and local assets.’ *Journal of International Business Studies* vol. 40 no. 9 (2009).

Jones, Geoffrey and Khanna, Tarun. ‘Bringing history (back) into international business’, *Journal of International Business Studies*, vol. 37, no. 4 (2006).

Lee, M., Yin, X., Lee, S., Weng, D. H. and Peng, M. ‘The impact of home country institutions on new venture export: examining new ventures in transition economies’, *International Entrepreneurship and Management Journal*, vol. 11, no. 4 (2015).

Morck, Randall and Yeung, Bernard. ‘History in perspective: comment on Jones and Khanna “Bringing history (back) into international business”’, *Journal of International Business Studies*, vol. 38, no. 2 (2007).

Narula, Rajneesh, and Alain Verbeke. ‘Making internalization theory good for practice: The essence of Alan Rugman’s contributions to international business.’ *Journal of World Business* vol. 50, no. 4 (2015).

Pan, Yigang, Lefa Teng, Atipol Bhanich Supapol, Xiongwen Lu, Dan Huang and Zhennan Wang. ‘Firms’ FDI ownership: The influence of government ownership and legislative connections.’ *Journal of International Business Studies*, vol. 45, no. 8 (2014).

Rugman, Alan M. 'The international financial crisis and multinational enterprise strategy', *Transnational Corporation*, vol. 20, no. 1 (2011).

Rugman, Alan M., Verbeke, Alain and Nguyen, Quyen T. K. 'Fifty years of international business theory and beyond', *Management International Review*, vol. 51, no. 6 (2011).

van Hoorn, André and Maseland, Robbert. 'How institutions matter for international business: institutional distance effects vs. institutional profile effects', *Journal of International Business Studies* (2016).

Zott, Christoph, Amit, Raphael and Massa, Lorenzo. 'The business model: recent developments and future research', *Journal of Management*, vol. 37, no. 4 (2011).

Chapter 2

GENERAL FRAMEWORKS IN INTERNATIONAL BUSINESS

Contents

Objectives of the chapter

In this chapter, we introduce several important conceptual frameworks that provide the reader with a toolbox to understand international business. First, we will introduce three important concepts: ownership advantages, location advantages and internalisation advantages, which are the pillars of two important frameworks, the eclectic paradigm and the FSA–CSA framework. The second part will introduce these two frameworks, which have many similarities and overlaps, and are both used frequently throughout this book. The FSA–CSA framework[1] is especially useful in understanding issues to do with strategy, while the eclectic paradigm helps to evaluate the broader aspects of international business. The eclectic paradigm, first developed by John Dunning, provides a consolidation of the literature on MNEs that draws on industrial organisation theories, location theory and market imperfections approaches. It is a basis for understanding almost all aspects of international business.[2] The two frameworks share some key concepts, which we will define first.

The first key concept used by both approaches holds that firms with access to particular kinds of assets are able to utilise these assets in foreign locations to engage in value-adding activities in those locations. These assets are variously described as ownership-specific (O) advantages or firm-specific advantages (FSAs). These two terms are used interchangeably throughout this book.

The second key concept is that assets that are not owned by a particular firm but are potentially available to all economic actors in a specific location (and are not mobile) are termed location-specific (L) advantages or country-specific advantages (CSAs).[3] Both terms are used interchangeably here.

The third part of this chapter will look at why firms become MNEs, and more specifically at what motivates them to go abroad. The fourth part will look at how firms engage in international activities and their internationalisation process; this part introduces the Uppsala model and the concepts of liability of foreignness, psychic distance and path dependence. The fifth part goes into detail of the entry modes that firms can opt for, such as greenfield, joint ventures, and mergers and acquisitions. The sixth part introduces the recent phenomenon of born-global firms, which are firms that have engaged in international activities since their establishment. The final part introduces the international activities of SMEs.

The specific objectives of this chapter are to:

1. *Introduce* some key conceptual frameworks from the international business 'toolbox', including the eclectic paradigm and the CSA–FSA framework, which capture ownership advantages, location advantages, and internalisation advantages.
2. *Explain* why firms become multinational enterprises (MNEs) – what motivates them to expand abroad.
3. *Understand* the internationalisation process, the Uppsala model and the concepts of liability of foreignness, psychic distance and path dependence.
4. *Describe* the international activities of small and medium-sized enterprises (SMEs).

ACTIVE LEARNING CASE

Starbucks: a global ‘coffee culture’

From its first location in Seattle’s Pike Place Market in 1971, Starbucks has grown into one of the largest coffee chains in the world. In 2018, Starbucks had 29,324 stores globally – an increase from the previous year, when it had 27,339. The company purchases and roasts high-quality coffee beans which are then brewed and retailed in trendy designer coffee shops that cater to a loyal following of young urban professionals, who appreciate the distinct taste of Starbucks’ coffee. In 2018 its sales were US$24.72 billion.

The company’s road to success began in 1985, when, after convincing the founders of Starbucks to test the coffee bar concept, the then director of retail operations, Howard Schultz, started his own coffee house to sell Starbucks coffee under the name Il Giornale. Within two years, Schultz purchased Starbucks and changed its company name to Starbucks Corporation. Since then, the company has expanded rapidly, opening stores in key markets and creating a ‘corporate coffee culture’ in each of the urban areas in which it settled. Coffee bars are located in high-traffic areas and include large bookstores, suburban malls, universities and high-traffic intra-urban communities.

Popularity has not come without a price for Starbucks. Coffee prices fell considerably in the late 1990s and led to the displacement of thousands of farmers. The main reason for a fall in the price of coffee was the oversupply that arose from improved production techniques and from a crop boom in the 1990s. Although Starbucks only purchases approximately 1 per cent of the global supply of coffee, its high profile has made it a main target for protestors who accuse the coffee giant of not providing a fair price to coffee growers; despite Starbucks’ policy of purchasing high-quality beans at premium market prices. To address the concerns of protestors, Starbucks introduced Fairtrade-endorsed coffee to its coffee houses. While the amount of Fairtrade coffee sold by the company is insignificant, at 1 per cent of total sales, it is enough to portray the company as progressive and avert a consumer boycott.

Source: wavebreakmedia/Shutterstock

The company directly operated 8,575 coffee houses in the United States in 2018. Unlike many coffee and fast-food chains, Starbucks does not franchise (license the right to operate one of its stores) to individuals in the United States. It does, however, negotiate licensing agreements with companies that have control over valuable retail space, such as an airport or hospital. In 2018, there were 6,031 Starbucks stores operating under licences in the US.

With coffee houses in over 75 countries, today Starbucks has a global presence. In contrast to its domestic operations, the majority of Starbucks' international operations are through licenses. Indeed, of 13,082 international stores in 2017, 8,319 were licensed and in joint venture, while 4,763 were directly owned. While Starbucks international stores represented around 48 per cent of the total number of stores, international revenues only made up about 26 per cent of total revenues in 2017. Starbucks has also adopted different international strategies in different countries: for example, in 1998, when it expanded into the UK, it did so through an $83 million acquisition of Seattle Coffee Company which had 60 outlets. The outlets were then rebranded as Starbucks. After failing to make gains in 2007, Starbucks, in 2012 formed a 50:50 joint venture with Tata Global Beverages in India, called Tata Starbucks. The joint venture has so far been seen as a success – after opening its first outlet in October 2012, it opened its 75th outlet in April 2015, and now has a presence in seven cities.

While Starbucks has had many successes in its international ventures, it was not successful in expanding to Australia. Starbucks first entered Australia in 2000 through a wholly owned subsidiary and opened several stores in quick succession. By 2008, however, it became apparent that Starbucks

had troubles and, from both cultural and financial pressure, it closed 61 of its 85 outlets. While Starbucks adapted its product line in China to meet the different needs of consumers, in Australia they failed to appreciate the differences between US and Australian preferences. Starbucks is branded as ‘affordable luxury’, but as analysts point out, Starbucks’ aggressive expansion meant its availability led it not to have a ‘luxury image’ but to be a symbol of American consumerism. In fact, Australians prefer smaller boutique-style coffee cafés, with personal touch and stronger-tasting coffee than was on offer at Starbucks.

More recently, Starbucks tapped into one of the most difficult coffee markets in the world: Italy. Though the founders pride themselves on the Milanese-inspired origin of the company, it took Starbucks 47 years to actually enter the country. Opening its flagship store on a trendy square in Central Milan in 2018, the company hopes to attract tourists as well as locals through its store’s luxurious and high-end design. Italians are famous for their coffee culture and are said to be sceptical of the American lifestyle. Nevertheless, Starbucks hopes to succeed in this difficult market, competing against local, cheaper coffee houses. For its goal, the company has sought help from various sources to make sure the Starbucks-in-Italy story becomes a successful one. For example, the retail giant entered a partnership with Percassi, a local brand management and real estate company. Whether these and other adaption-related efforts allow Starbucks to succeed and help it win the Italians’ hearts, is a question that (for now) remains to be written in the stars.

Sources: http://www.starbucks.in; http://www.statista.com/topics/1246/starbucks/; http://www.tataglobalbeverages.com/company/tgb-at-a-glance/about-us; ‘Starbucks in $83 million deal for British coffee chain’, *New York Times*, 30 April 1998; P. Mercer, ‘Shunned Starbucks in Aussie exit’, *BBC News*, 4 August 2008; A. Lutz, ‘Starbucks has failed in Australia’, *Business Insider*, 28 May 2014; https://www.forbes.com/sites/jennawang/2018/09/13/why-it-took-starbucks-47-years-to-open-a-store-in-italy/#b0a5c1fc005c.

1. **What are Starbucks’ firm-specific advantages?**
2. **Why is Starbucks focusing its international expansion on emerging countries, such as India?**

3. **Can you find any examples of Starbucks facing inter-regional liability of foreignness?**
4. **What are the advantages of Starbucks using licensing and joint ventures when expanding abroad?**

INTRODUCTION

Certain core concepts and frameworks are crucial to understanding international business activity and its relationship to strategy and innovation. These concepts are the focus of Chapter 2. There are two key frameworks that any student of international business needs to master: the eclectic paradigm and the FSA–CSA framework. The eclectic paradigm is a more general framework and is useful in understanding a variety of different issues. It is a toolbox in its own right, and helps us understand countries, modes of governance and government policies, and it is used by policy-makers. It can be applied at a macro (country) level, as well as at an industry and firm level. The FSA–CSA framework finds its greatest application in understanding the strategy of firms. Both frameworks share two crucial aspects – ownership advantages/firm-specific advantages, and location advantages/country-specific advantages. The third ‘leg’ of the eclectic paradigm are internalisation advantages, a concept that is implicitly acknowledged by the FSA–CSA framework.

FIRM-SPECIFIC *ASSETS* VERSUS FIRM-SPECIFIC *ADVANTAGES*? IS THERE A DIFFERENCE?

Both the eclectic paradigm and the FSA–CSA framework use the term 'advantage' to describe their key building blocks (ownership *advantages*, firm-specific *advantages*, location *advantages*, country-specific *advantages*).

The use of the term 'advantage' implies a comparison in some way, because an advantage is a superiority *relative* to something else. A proprietary asset can be an advantage, sometimes only by its possession, but in many cases, the mere possession of an asset does not automatically result in an advantage. In reality, however, firms can rarely determine the relative superiority of their assets vis-à-vis other firms (i.e., competitors) with any degree of confidence, because it is hard (if not impossible) to know the value and nature of the proprietary assets of another firm.[4] The nature of knowledge is that it is tacit, and often integrated into products and processes, or indeed resides in the minds (or the databanks) of the employees of the firm. The value of an asset, and whether it confers an advantage, is a judgement that economic actors must make. However, this is a judgement based on incomplete information, and firms often find out after entering a market that their assets were not 'advantages'.

Therefore, strictly speaking, the term 'firm-specific asset' and 'firm-specific advantage' mean rather different things! However, because the use of the term 'advantage' is in common use, we will adhere to this tradition throughout the book.

FIRM-SPECIFIC ADVANTAGES/OWNERSHIP ADVANTAGES

Firms need to have assets that they are able to use in foreign locations to generate some kind of income. These assets are variously described as *ownership-specific (O) advantages*, *firm-specific advantages* or *firm-specific assets (FSAs)*. The academic literature has tended to use these terms interchangeably.[5]

FSAs are important to understanding competitive advantage. The competitiveness of firms results from the ownership of proprietary assets that are efficiently combined with value creating activities, and that are difficult for competing firms to mimic. Over the long term, however, competitive advantage (and the returns associated with it) tends to be eroded either through the depreciation of assets or by their imitation by rival firms. Therefore, to maintain their FSAs, firms must continuously upgrade their assets.

The understanding of ownership advantages in the international business field is based upon Hymer's (1976) monopolistic advantage theory. The theory was developed after neo-classical theories in economics proved ineffective in explaining how foreign firms were able to compete against domestic firms. Hymer argued that the MNE's success lies in its access to a 'package (bundle) of resources' including technology and management skills that offered the owner monopolistic advantages to outcompete indigenous firms. These monopolistic advantages were either (a) not available to local firms, or (b) superior to the assets of local firms. Essentially, ownership advantages allow the business to overcome the barriers of entry into the host country. It is important to note that foreign firms are innately in a disadvantaged position in comparison to the home country's domestic companies when they enter the host country, considering they do not have networks, experience or local

knowledge, and therefore will need to offer something superior to compensate for this disadvantage.

A classification of O advantages

Ownership advantages are firm-specific in nature, and the competitiveness of firms is associated with the strength (or weakness) of their O advantages.[6] There are three types of O advantages (Figure 2.1).

Asset-type FSAs

This type of FSA involves the ownership of physical equipment, intellectual property or privileged access to tangible and intangible resources (including knowledge possessed by employees, as well as access to financial capital). It is common to think of such FSAs as having mainly to do with technology/engineering, such as new products, services and processes, machinery and equipment, and intellectual property. However, this type of FSA also includes privileged knowledge about where to find resources (i.e., in which particular locations), how to get privileged access to these resources, and at what price, relative to alternative locations. A firm may have the 'know-who' which allows it to get a long-term lease to a copper mine in Zambia at a favourable price. Such knowledge is valuable to generating an income, even if it does not have technological assets, such as machinery or know-how. It can partner with another firm that does have these technological assets, through either a non-equity partnership or an equity joint venture.

Transaction-type FSAs

These advantages are associated with conducting transactions efficiently. Firms can generate an income because they know how to organise themselves efficiently, both within countries and internationally. They are complementary to asset-type FSAs, and if a firm wants to be a successful MNE, it must know how to develop an organisational structure that allows it to benefit from the

synergies of having operations in more than one country. This is known as *advantages of common governance*. If a firm has simply duplicated all its management and operations from its home country in the host country, it is unlikely to be successful abroad, because the L advantages in the host country are different from the home country. However, just as importantly, it must find synergies that allow it to reduce duplication, and exploit complementarities while reducing duplication. If it can establish a common human resource management department, and common finance and accounting facilities, or is able to get loans more cheaply because it is borrowing for both operations at the same time, it is exploiting these economies of common governance. They are to do with managerial skills associated with efficiently running a complex organisation, and encompass leadership, human resource capabilities, logistics, and creating and implementing organisational structures. They are about creating and maintaining routines within an MNE, and establishing efficient bureaucracies. In other words, the ownership of asset-type FSAs needs to be complemented by the ability to distribute these assets effectively to other constituent parts of the MNE, so they can generate profits. However, simply having transaction-type FSAs without any asset-type FSAs rarely leads to rent generation.[7]

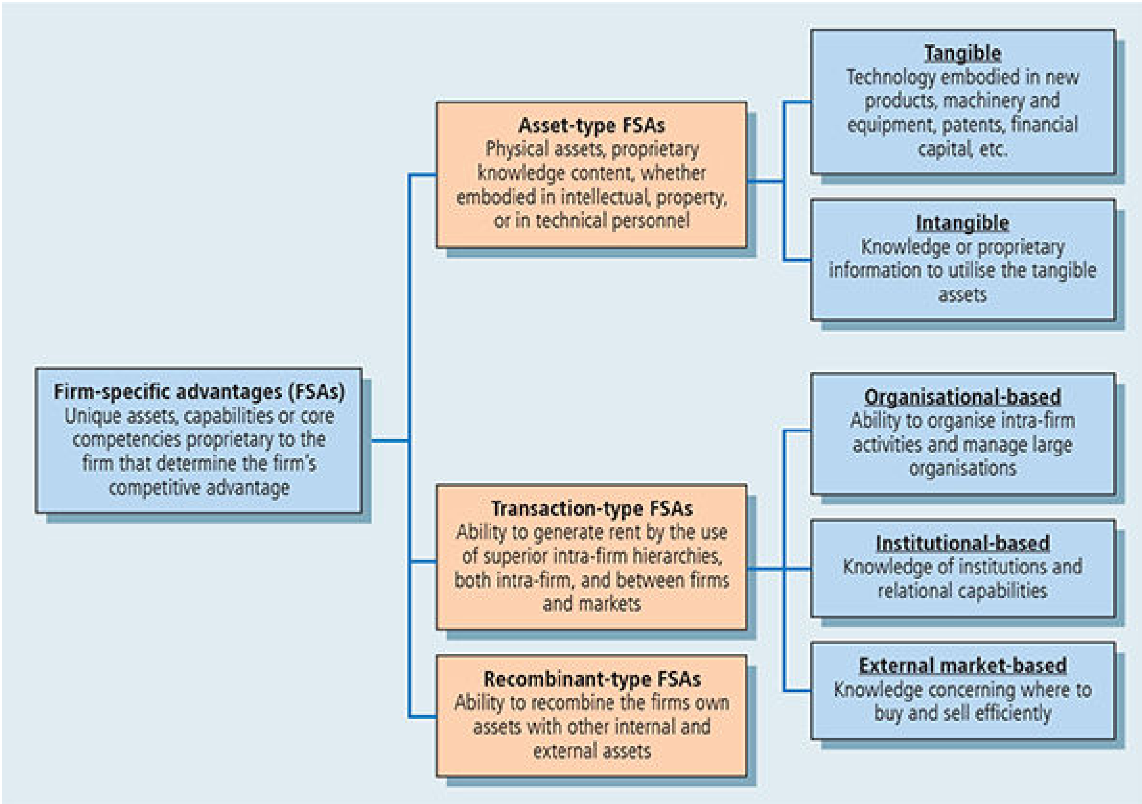

Figure 2.1 Classes of FSAs or ownership (O) advantages

It is important to distinguish between the O advantages of the MNE at large, and those associated with individual establishments or subsidiaries (Rugman and Verbeke, 2001).[8] Much of the early literature on O advantages took a macro perspective, given the nature of the typical MNE and its centralised management structure. Such centralised MNEs had O advantages that were in principle available to all their subsidiaries. However, today this is not always so. The O advantages of the parent are not necessarily available to all its-subsidiaries, and to each individual operating unit, and vice versa.

Transaction-type FSAs are about being able to conduct internal transactions efficiently, and the MNE should be able to conduct transactions more efficiently with external markets as well. An MNE must be a **meta-integrator** because it needs to do two things well. First, it must be able to move knowledge, goods, ideas and people between its various establishments in different locations and countries to create this efficiency. Second, it must

efficiently move goods, services, ideas and people from and to unaffiliated firms outside the boundaries of its firm, especially where these are cheaper than those available internally. To do so requires knowledge of institutions. A familiarity with institutions plays an important part in reducing the coordination costs, the costs of opportunistic behaviour, and other transaction costs.[9] Knowledge of institutions makes it cheaper to conduct transactions. Not least, a firm that is familiar with the major actors in its host economy and how to best approach them can be much more competitive than a firm that does not have good connections with state-owned organisations, ministries and policy-makers.

Recombinant FSAs

Recombinant advantages are an important set of FSAs, which represent capabilities for the re-combining or 'bundling' of complementary assets to improve their performance.[10] Firms require a certain threshold of assets – both transaction-type and asset-type FSAs – to successfully compete in any given country, and these different assets must be 'bundled' together. Where a firm is deficient in one type of FSA, it can nonetheless continue to be competitive, overcoming this weakness by leveraging other assets outside its own boundaries. This is an expertise that is not easily acquired or transmitted. Such expertise is a firm-specific advantage in its own right.

Not all advantages are equally mobile across borders. *Location-bound* O advantages allow the firm to generate profits, but only in a specific location. For instance, an MNE might have privileged access to natural resources, to capital or specific infrastructure in its home country. It cannot use these FSAs in its host country, so they are considered to be location-bound.

MNEs can be part of a large industrial group at home (sometimes with cross-holdings and common ownership) with interests in several industries. Such linkages provide privileged access to intra-group transactions and intermediate goods within the same family of firms, but these advantages are

not necessarily available when they move abroad. These may also derive from knowledge of institutions, by virtue of being an 'insider'. They may have close relationships with state-owned organisations, ministries and policy-makers, and be able to influence domestic policy. They may be able to shape the technology and science infrastructure to their own needs, and in many cases these will have evolved around and with their own domestic activities, often over a long period of time. Such linkages confer the basis to generate economic rent for incumbents, and are a cost to new entrants or those less entrenched in the domestic milieu. These advantages are not transferable to foreign markets, and establishing 'membership' in business and innovation networks in new locations is not costless.[11]

Active learning check

Review your answer to Active Learning Case question 1 and make any changes you like. Then compare your answer to the one below.

1 What are Starbucks' firm-specific advantages?

The most obvious FSA of Starbucks is its brand. This is why it was so important for Starbucks to shift to fair trade, so it could keep up its image of luxury, while maintaining a good corporate social responsibility (CSR) image. Other important FSAs include being able to identify prime and strategic locations, and benefit from economies of scale derived from its global distribution channels and bargaining power over suppliers.

LOCATION ADVANTAGES/COUNTRY-SPECIFIC ADVANTAGES

Assets that are not specific to a particular firm but are potentially available to all actors in a specific location (and are not mobile) are termed *location-specific (L) advantages* or *country-specific advantages (CSAs)*. L advantages are about the characteristics of specific locations, and are location-bound. Although it is increasingly popular to use country-specific advantages as a synonym for L advantages, the term 'L advantages' allows us to clearly distinguish between the various units of analysis, such as the country, national sub-regional or supranational regions. Even within countries, sub-national regions have different types of assets. Supranational regions also exist – such as the European Union (EU) – which provide an additional layer of policies, regulations and laws. An MNE may engage with all three levels of L advantage. For instance, consider an MNE with a production site in Maastricht, in the Netherlands. The MNE will need to consider the L advantages of the Netherlands at large, the Limburg province, as well as the EU.[12]

L advantages are in principle accessible to all firms equally that are physically or legally established in that location. We say 'in principle' for two reasons. First, full information about L advantages associated with a specific location may not be readily available. Their unavailability may be because there are 'costs' associated with accessing this knowledge. This knowledge may be available to incumbents (whether domestic or foreign), and acquired through experience. Second, these L advantages may be made available (or denied) by the actions of governments that seek to encourage (or restrict) the activities of a particular group of actors by introducing barriers to their use of certain L advantages. This may be for commercial reasons (to favour a national firm over the MNE), or for strategic reasons such as national defence, or it may

reflect the influence of interest groups that are able to influence government policy.

When location-bound advantages are in the private domain (i.e., they are internalised by others), they are no longer L advantages but constitute O advantages, since they assist rent generation/market share retention by specific actors to the exclusion of other economic actors.

A classification of L advantages

It is important to understand that L advantages are about relevant complementary assets outside the boundaries of the MNE (or other firm actors) that are location-bound. Table 2.1 classifies L advantages into several broad categories. For each of these categories, we identify the specific type of L advantages and related sources and provide examples. As we discuss below, these categories have a certain degree of overlap.

Table 2.1 A classification of L advantages

Level	Type of L advantages	Sources of L advantages	Example of L advantages
Macro-region/country level L advantages	Exogenous L advantages	These derive from natural assets (independent of development stage)	• Sociological/anthropological • Culture, norms, religion, political stability. • Land availability, rainfall, climate, extractive resources, basic population • Proximity and accessibility to other markets • Membership in a regional integration scheme
	Fundamental L advantages	Basic infrastructure	• Primary schools • Health care • Transport (roads, railways) • Utilities (electricity, water) • Telecoms • Ports • Efficient bureaucracy • Public transport
		Legal infrastructure	• Legal system • Security and police • Tariff system • Property rights • Tax and excise
		Regulation and policy	• Incentives • Subsidies • Tax holidays • Regulatory agencies • Industrial policy • Competition policy • Capacity to enforce regulation
Industry-level L advantages	Knowledge asset L advantages	Financial infrastructure	• Banking, insurance, stock exchange
		Knowledge infrastructure	• Tertiary education, universities • Public research institutes
Firm-associated L advantages	Structural L advantages	Market and demand structure	• Income level and distribution • Size of potential market • Consumer sophistication • Wage rates • Skilled employee availability • Distribution channels • Competitors?
	Collocation L advantages	L advantages that derive from the presence of other actors in the same location	• Agglomeration economies • Networks of suppliers • Networks of customers • Presence of support industries
		Industrial policy	• Specific policies associated with given industry
		L advantages that derive from location-bound O advantages of other actors	• Presence of significant customer • Presence of significant supplier

Source: Adapted from Narula and Santangelo (2012).

Country-level L advantages

These are 'contextual' in nature, because they provide the broad background of a location. They reflect the socio-economic and political environment. They remain macro and 'generic' and are relevant to all firms, regardless of size, nationality, industry or geographical unit of analysis. Some are exogenous, in

the sense that they are independent of the economic stage of development, and are the natural assets of the location, such as population, climate, accessibility, etc. Others are generic because they 'should' exist in all nation states, even though there are countries where they are not easily available – these include basic infrastructure, legal and financial infrastructure, and regulation and policy frameworks.

The last sub-category represents L advantages that are regarded as knowledge infrastructure. 'Knowledge infrastructure' refers to public research institutes, universities, statistical organisations, national standards and testing laboratories, intellectual property protection, etc., that enable and promote science and technology development. For obvious reasons, this can also be categorised as an industry-level L advantage, since such assets may be specifically geared to a particular set of industries.

Industry-associated L advantages

In making an investment decision, MNEs seek specific, industry and market-related complementary assets. For instance, an IT firm will establish software design facilities where there is a large supply of IT graduates. Demand is also industry-specific. A luxury furniture firm will be interested in seeking out a market for other luxury goods, opportunities for distributing its goods through channels specific to luxury goods, and the competition within that specific sector. Industry policy is often industry-specific. A location which is home to a cluster of firms in a similar industry is likely to have access to a number of suppliers in support and related sectors. Governments may also provide specific incentives and policies to promote a specific sector, which may make a location more attractive for a specific industry, and not for others.

Informal institutions deserve special mention as an L advantage. Informal institutions shape the manner in which economic actors in a given location interact *in practice*. Such knowledge is also in principle available to all firms that seek to acquire it, but because informal institutions are largely tacit,

physical proximity is crucial in its acquisition. In other words, it requires some degree of embeddedness to acquire. Embeddedness in a location provides membership to a ‘club’ of complex relationships with suppliers, customers and knowledge infrastructure through formal and informal institutions, and these institutions have taken years to evolve a stock of knowledge that is only available to members by virtue of their constant interaction.[13]

Active learning check

Review your answer to Active Learning Case question 2 and make any changes you like. Then compare your answer to the one below.

2 Why is Starbucks focusing its international expansion on emerging countries, such as India and China?

India has a fast-growing economy, with the second largest population in the world. With Starbucks targeting 'trendy' 25- to 40-year-olds, the growing middle class and more Indians with disposable income, this is a good market opportunity. This is especially important for companies such as Starbucks where developed countries are increasingly seen as saturated markets. Notably, as of 2018, China represents the second country (following the United States) with the highest number of Starbucks stores. With growing incomes among the Chinese and a taste for Western lifestyles and brands, China is indeed an attractive market for Starbucks. The company aims to operate 5,000 stores in the country by 2022.

INTERNATIONAL BUSINESS STRATEGY IN ACTION

US manufacturing: from China to Mexico

Offshoring has been reported as a declining trend for many nations and recently China has been under pressure concerning this strategy, as costs associated with wages, currency, fuel and transportation are factors contributing to the decline of offshoring within China. Many firms are now appreciating the fact that offshoring in emerging countries, such as China, is costlier than initial predictions and are either moving production back home or finding alternative, cheaper locations, such as Mexico. Furthermore, analysts suggest that manufacturing in China is almost as expensive as manufacturing in the US.

With increasing costs in China, US manufacturing firms of all sizes are seeking to open plants in Mexico. Economists have reported that these US manufacturing firms are eager to expand operations in Mexico because, unlike China, it continues to hold relatively low labour costs. In addition, US firms opening plants in Mexico will have relatively low transportation costs with huge advantages in terms of ease when accessing the American market. Since 2010, the US's trade with Mexico has grown by approximately 30 per cent, with annual figures of $507 billion. Furthermore, FDI figures from the US to Mexico reached $35 billion in 2013.

Figure 2.2 illustrates the comparative cost of shipping a 40 ft container to the US from China and Mexico. Due to the rise in oil prices, the cost of shipping from China to the US increased from approximately $3,000 to $7,600 between 2000 and 2012. In contrast, the costs of shipping from Mexico to the US increased from approximately $1,900 to $2,800 within the same time period. Furthermore, factors such as distance and customs have resulted in the difference in time from Mexico to the US, and China to the US, reaching up to three weeks.

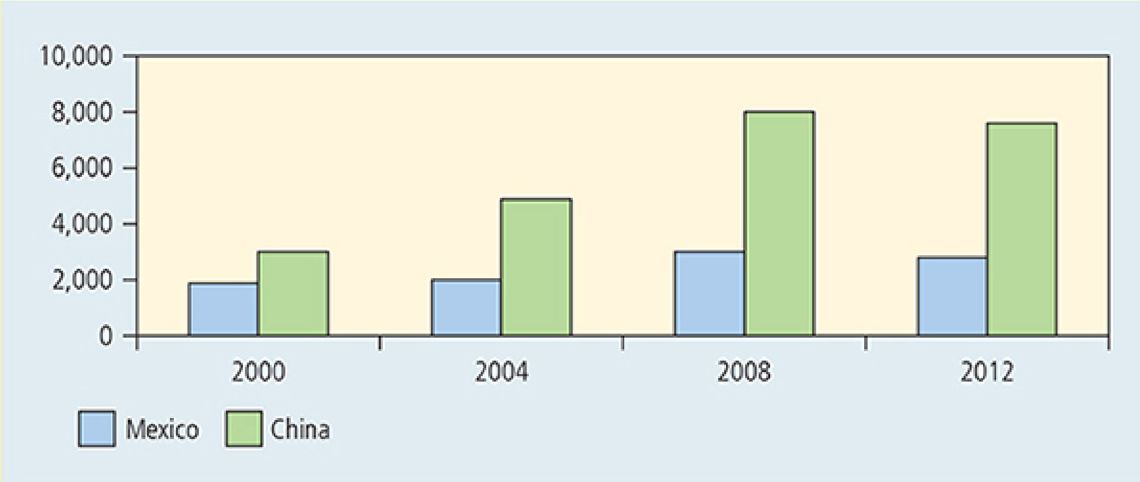

Figure 2.2 Cost of shipping a 40 ft container to the American East Coast (US$)

Source: http://tacna.net/mexico-vs-china/.

Table 2.2 China's and Mexico's market share (%) in the global automotive industry, 2005–13

	2005	2006	2007	2008	2009	2010	2011	2012	2013
China	17.06	16.26	10.80	13.06	15.16	13.99	13.58	12.71	12.40
Mexico	1.93	4.28	3.85	4.35	5.75	4.53	5.05	9.05	12.56

Note: Based on number of greenfield FDI projects.

FT

Source: James Kynge (2015), Mexico steals a march on China in car manufacturing, April 21 https://www.ft.com/content/0bc33e06-e81e-11e4-894a-00144feab7de.

Evidently many US-based MNEs such as Caterpillar, Chrysler, Stanley Black & Decker and Callaway Golf are moving or expanding into Mexico, which has helped Mexico secure billions of dollars of investment. Even though a growing number of firms producing high-technology products are reducing operations within China and moving to Mexico, it has been reported that firms producing low-technology products such as headsets (Plantronics), hula hoops (Hoopnotica), toilet brushes (Casabella), outdoor furniture (Meco Corporation) and industrial cabinets (Viasystems Group) have also reduced or closed operations in China and moved to Mexico.

The automotive industry has also been identified as an industry increasing operations in Mexico in comparison with China, following an increase of 16.8 per cent in the average salary in the industry between 2009 and 2014. Observing Table 2.2, by 2013 Mexico had surpassed China in terms of global foreign direct investment in the automotive industry as the number of greenfield FDI projects reached 12.56 per cent. It is apparent that Mexico's market share in the global automotive industry has been increasing significantly, rising from 1.93 per cent in 2005 to 12.56 per cent by 2013. In contrast, China's market share in the global automotive industry decreased from 17.06 per cent in 2005 to 12.4 per cent in 2013. In 2015 Volkswagen announced that it would be investing US$1.5 billion in Mexico for the production of small SUVs. In addition, other automotive original equipment manufacturers (OEMs) such as Nissan Motors, General Motors, Ford Motors and Fiat Chrysler have also announced they will be increasing operations within Mexico.

Since 2009, wage rates have increased more dramatically in China than in Mexico. In absolute terms, wage rates in China are significantly higher than in Mexico for unskilled workers. For instance, in 2014, an average unskilled worker in an automotive plant located in Mexico could be expected to earn $3,645 annually, compared to $5,726 in China. However, wage rates remain lower in China for engineers and high-skilled workers. Table 2.3 illustrates the changes in annual salaries for the workforce in the automotive industry in China and Mexico. Even though the annual salary in the automotive industry increased by 16.71 per cent in Mexico in 2014, the mean growth in salary for automotive workers between 2009 and 2014 was 4.9 per cent in Mexico and 16.8 per cent in China. It has been argued that Mexico's relatively predictable, steady wages offer firms a sense of certainty when forecasting manufacturing costs for the future.

Foreign exchange rates can also help to explain why firms may be favouring Mexico over China, as slight changes can have large effects on an organisation seeking to expand operations. From 2003 to 2013, it has been noted that the Chinese yuan has become 26 per cent more expensive in relation to the US dollar. In contrast, the Mexican peso has actually become 27 per cent cheaper in relation to the US dollar.

Another factor that helps to explain why firms may prefer Mexico revolves around trading alliances. Including the North American Free Trade Agreement (NAFTA), Mexico currently has free trade agreements with 45 countries. Even though China aims to have 20 free trade agreements in place

in the near future, as of 2015 they had only 12 agreements. Therefore, Chinese products are constantly hitting tariff barriers when entering crucial markets within North and South America.

Table 2.3 Growth in annual salary costs within the automotive OEM workforce (% change), 2009–14

	2009	2010	2011	2012	2013	2014
China	14.4	8.92	32.93	22.31	11.07	11.25
Mexico	10.06	−8.93	6.12	−0.75	6.17	16.71

Source: James Kynge (2015), Mexico steals a march on China in car manufacturing, April 21 © Financial Times Limited 2019. All rights reserved https://www.ft.com/content/0bc33e06-e81e-11e4-894a-00144feab7de.

Conclusion

Even though expanding operations in Mexico may result in job reductions in the USA, economists suggest that overall the American economy is likely to benefit more in the long run when firms decide to locate in Mexico rather than China. For instance, neighbouring countries often share high levels of production levels. The National Bureau of Economic Research found that approximately 40 per cent of the components identified in Mexican imports actually originated from the US itself, which is significantly higher than the 4 per cent found in Chinese imports.

Multiple factors such as labour costs, currency trends, fuel costs, transportation and trading alliances have inevitably led to many organisations favouring Mexico over China. However, this does not necessarily mean China's manufacturing industry will be diminished in the long run. Costs alone may not be sufficient for businesses to leave China, as the nation has been argued to contain some of the world's best supply chains of components and infrastructure. Furthermore, firms have already invested heavily in China. Having initially ventured there for low labour costs, they may not want to leave the country now, as the domestic market has itself become huge.

China displaced the US in 2010 as the largest manufacturing country in the world, and has invested heavily in automated manufacturing. The International Federation of Robotics has estimated that China's stock of operational robots in the automotive industry is likely to more than double to 428,000

machines. Even though the Chinese economy may not be able to compete with low labour costs from other nations such as Mexico, China might not actually require as vast a labour force as previously, as it is set to be the world leader in automated robotic manufacturing instead.

Sources: http://tacna.net/mexico-vs-china/; Damien Cave, 'As ties with China unravel, US companies head to Mexico', *New York Times*, 31 May 2014; James Kynge, 'Mexico steals a march on China in car manufacturing', *Financial Times*, 21 April 2015; Reshoring Manufacturing, 'Coming home', *The Economist*, 19 January 2013; Tia Nowack, 'Manufacturers are leaving China, but where are they headed?,' 28 January 2014, manufacturing.net; Schim Sau-wai, 'Cheaper costs beckon manufacturers from China to Mexico', *South China Morning Post*, 15 February 2015.

Internalisation advantages

The eclectic paradigm consists of three important building blocks, two of which are FSAs and L advantages. The third building block is the *internalisation advantage.* This comes from internalisation theory, pioneered by Peter Buckley and Mark Casson, and developed further by Alan Rugman, Jean-François Hennart and Alain Verbeke, among others.[14] 'Classical' internalisation theory is built on three premises. First, firms tend to maximise profits in the world of imperfect markets. Second, the existence of an imperfect market for intermediate goods provides firms with an incentive to create internal hierarchies to control such activities. Third, where imperfect markets exist, the internalisation of markets creates MNEs because they are the most efficient way to facilitate and control the coordination of interdependent economic activities domestically or across geographies as compared to the coordination of such activities through the market. This is the internalisation (I) advantage, and where there are advantages to the firm of internalising such activities, it will do so. I advantages largely determine what entry mode (e.g., exporting, joint venture or wholly owned subsidiary) the firm will adopt when it decides to operate in a foreign location. We discuss entry modes later in this chapter.

Internalisation theory is linked closely with transaction cost theory (the cost associated with economic exchange). As there are costs with doing business in the market, a firm has to see whether keeping operations internally as opposed to leaving them to a third party would mitigate transaction costs. That is the main question internalisation theory sheds light on. There are several reasons why a firm may want to keep its activities internal instead of leaving them to the market (e.g., outsourcing production). It could be that the firm's ownership advantage is in production and that outsourcing it to a third party could lead to some leakage to competitors. It could be that the firm is able to do it at a cheaper price internally or it could be that the company wants more control over quality.

THE ECLECTIC PARADIGM: PUTTING IT ALL TOGETHER

The eclectic paradigm[15] (sometimes known as OLI) connects the three building blocks together. It is easiest to think of the OLI framework as answering a set of three sequential questions (Figure 2.3):

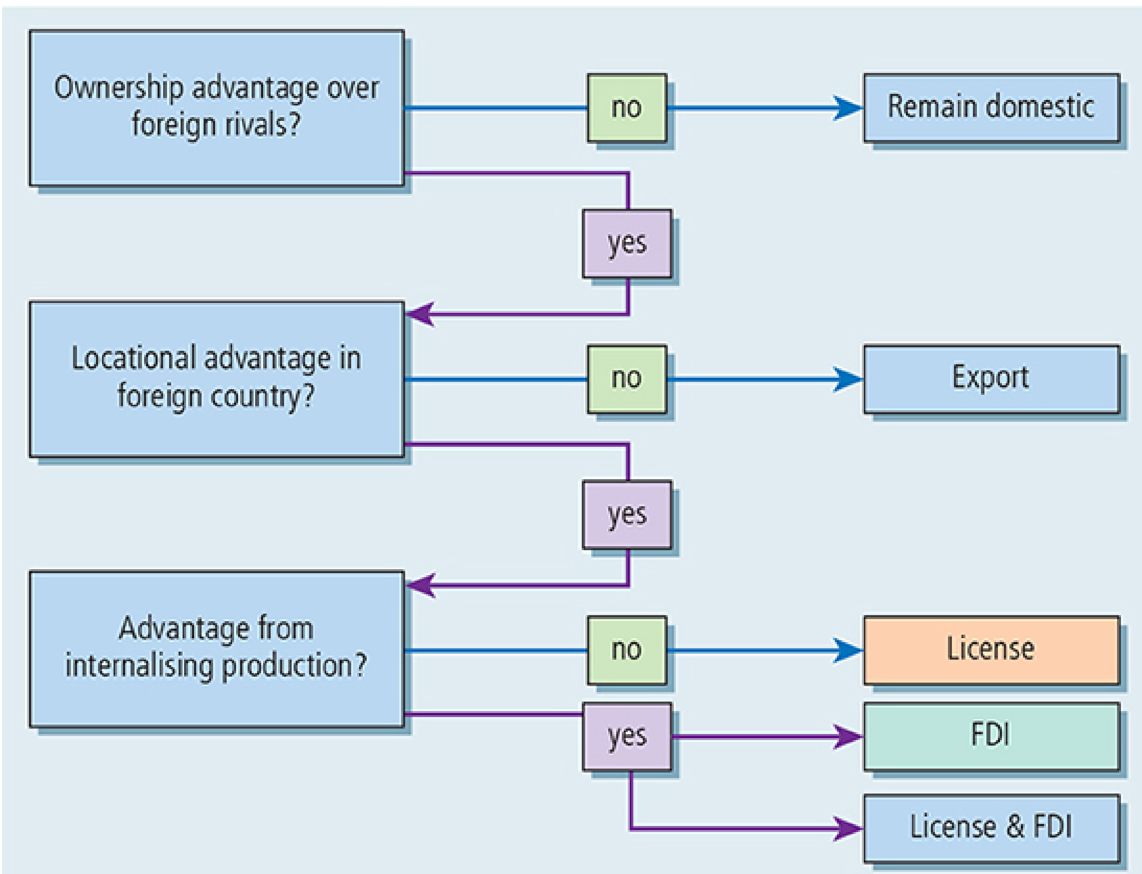

Figure 2.3 The OLI Framework: a decision model

1. Does the FSA of the firm provide it an advantage over other firms operating in the intended destination location? If the answer is 'no', then the advantage is a domestic one, and the firm should not internationalise. Note that determining whether an FSA provides an advantage requires us

to systematically analyse this, and this is best done using the VRIO framework, which we introduce in Chapter 3. If the answer is ‘yes’, the firm’s FSAs provide it with an advantage over other firms in the foreign location, and we can move to the second question.

2 Can this FSA be used abroad, in conjunction with the location advantages of the host location? Are the location advantages of this location complementary to the FSAs of the firm? As we discussed earlier, not all FSAs are ‘stand-alone’. They depend upon inputs that are location-bound. Let us suppose firm A (from Argentina) owns technology that provides it with an FSA (for instance, patented technology to produce rechargeable batteries), which it has hitherto been manufacturing in its home country. A key input for its manufacturing is specific raw materials, which the Argentinian government makes available at very low prices. This is a location advantage of its home country, and it is location-bound. If firm A wants to manufacture these batteries in Sri Lanka, the decision will depend upon whether these same raw materials can be acquired in Sri Lanka at a lower cost. It could also be that the raw material is not cheaper, but some other important input is low enough that it compensates for this, such as the cost of labour. If the answer is ‘yes’, that is an overall advantage of producing in Sri Lanka rather than in Argentina (or another location) because of Sri Lanka’s L assets, in which case we can move to the third question. If the answer is ‘no’, then it needs to consider supplying the Sri Lankan market by exports, rather than FDI.

3 If there is a clear FSA, and there is a clear L advantage of the destination location, the next question the firm has to answer is: Are there any advantages for firm A from manufacturing in Sri Lanka itself, rather than allowing others to do so on its behalf? It may be that it does not have the prerequisite knowledge of the foreign market to be able to do this itself, or there may be barriers to entry of new foreign firms. If this is the case, it may prefer to license its technology to a local firm (or another firm

already located there) rather than engaging in direct investment. In a service industry, the choice would be to franchise, rather than engage in FDI. The firm needs to conduct a cost–benefit analysis of the different entry modes to determine which would be economically most beneficial to it, and thereby to decide whether to internalise the foreign market or not, and if so, to what degree it wants to take on control and ownership of its foreign affiliate.

Of course, the issue of entry mode choice is a complex one, and firms can often undertake complex combinations – it may seek to license as well as make a joint venture, for instance. Furthermore, we know from Chapter 1 that it is possible to control a foreign operation without necessarily engaging in ownership. We will discuss this at some length later in the chapter.

STRATEGIC MANAGEMENT OF MNEs: AN INTRODUCTION

The strategic management process involves four major functions: strategy formulation, strategy implementation, evaluation and the control of operations. These functions encompass a wide range of activities, beginning with an environmental analysis of external and internal conditions and an evaluation of organisational strengths and weaknesses. These activities serve as the basis for a well-formulated strategic plan, and by carefully implementing and controlling this plan, the MNE is able to compete effectively in the international arena.[16] Figure 2.5 illustrates the five specific steps in this overall process.

Steps in the strategic management process

Strategic planning typically begins with a review of the company's *basic mission*, which is determined by answering the questions: What is the firm's business? What is its reason for existence? By answering these questions, the company clearly determines the direction in which it wants to go. Shell Oil, BP and Chevron, for example, see themselves as being in the energy business, not in the oil business, and this focus helps to direct their long-range thinking. AT&T and France Telecom view themselves as being in the communications business, not in the telephone business. Similarly, Coca-Cola and PepsiCo see themselves in the food business, not in the soft drinks business. This point is also highlighted by Coca-Cola's 2018 acquisition of British coffeehouse chain, Costa Coffee. This £3.9 billion acquisition allowed the company to tap into the hot beverages market.

A growing number of MNEs have revised their strategic plans because they realised that they had drifted too far away from their basic mission. Unilever,

the giant Anglo-Dutch MNE, is a good example. After assessing its operations, the company concluded that it needed to adopt a 'back to the core' strategy. As a result, it sold a wide range of peripheral operations, including transport, oil, milling, wallpaper, floor coverings, specialty chemicals and turkey breeding. Today Unilever confines its business to consumer product goods: food, health and wellness products, personal care and home care. The firm's strong research and development (R&D) labs continue to develop new products in each of these areas, thus helping Unilever to remain competitive in worldwide markets.[17] Another example is IBM, the American technology giant that realised it had moved too far away from its hardware core business. The company decided to divest from its semiconductor technology business, which for years had seen minimal growth expectations. Prior to this strategic move, IBM had sold off its x86 server business to Lenovo, a Chinese multinational technology company with headquarters in Beijing. Notably, these are only two among many cases of firms that revisited their basic mission.

Understanding the mission of a firm is not the same thing as its strategy. A firm's mission may be a financial one, focused on profits, on market share or on a social objective. It declares the values that the organisation holds dear, the organisation's reason for existing and its outlook for internal and external audiences, for instance, its employees, consumers and shareholders. A mission statement precedes, and in many ways, constrains and shapes its strategy. Google's mission talks about 'organizing the data around the world and making it a widely available and useful resource'. A mission statement is used to motivate employees by defining the values they need to aspire to. It acts as a reference point, an envelope for their actions. The NGO, Save the Children, defines its mission as, 'A world in which every child attains the right to survival, protection, development, and participation.'

After determining its mission, an MNE will evaluate the external and internal environment. Figure 2.4 summarises a variety of frameworks available

to undertake both internal and external environment analysis, and indicates which chapters in this book they are discussed.

The goal of *external* environmental analysis is to identify opportunities and threats outside the firm. This requires a systematic analysis of its location advantages, as well as its CSAs. Key frameworks to map the external environment require a view at both the industry and the country level (Figure 2.4). External environmental assessments are discussed in more detail in Chapter 15.

The purpose of *internal* environmental analysis is to evaluate the company's financial and personnel strengths and weaknesses. Examining its financial picture will help the MNE decide what it can afford to do in terms of expansion and capital investment. Examining its financial picture will also help it to identify areas where cost cutting or divestment is in order. By making an evaluation of its personnel, an MNE will be able to determine how well its current workforce can meet the challenges of the future and what types of people will have to be hired or let go. In addition, the firm might like to include in its internal environmental analysis the reputation of its products, the structure and culture of its organisation, and its relationship with suppliers.

Internal analysis requires an intimate understanding of its competitive advantages. In many cases, firms undertake a VRIO analysis of their tangible and intangible assets to determine what best provides them a long-term advantage over their competitors. That is, firms need to examine their portfolio of resources critically, so that they can distinguish their 'resources' from their 'capabilities'. The VRIO framework and dynamic capabilities are explained in Chapter 3. Understanding and implementing strategy depends crucially on understanding the make-up (and sustainability) of the firm's FSAs, and this in turn requires a more precise understanding of how the firm plans to innovate, since the capabilities of the firm need to be continually upgraded over time (also discussed further in Chapter 3).

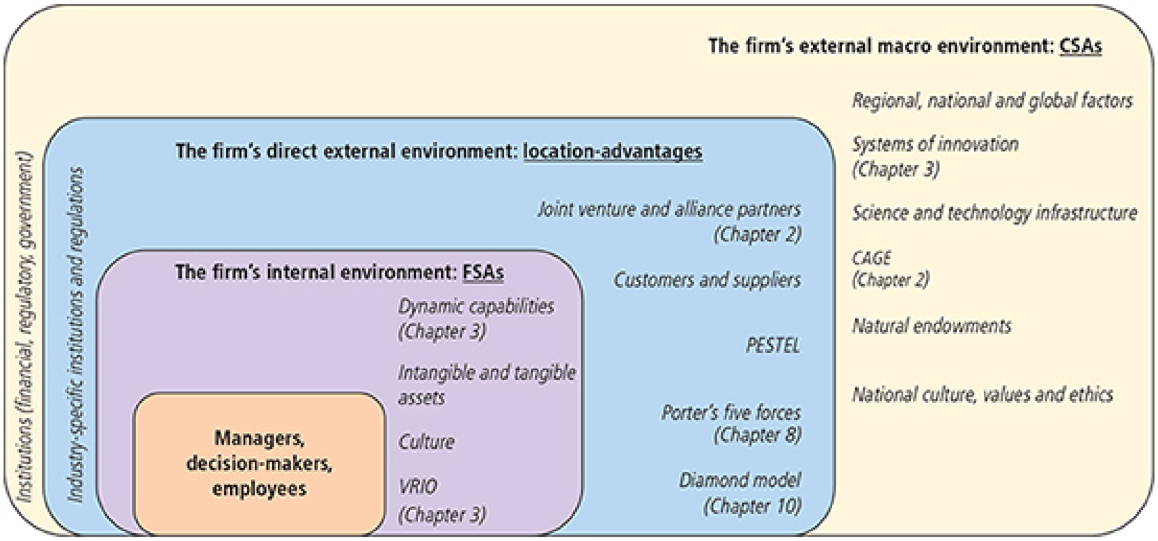

Figure 2.4 **Frameworks for internal and external analysis**

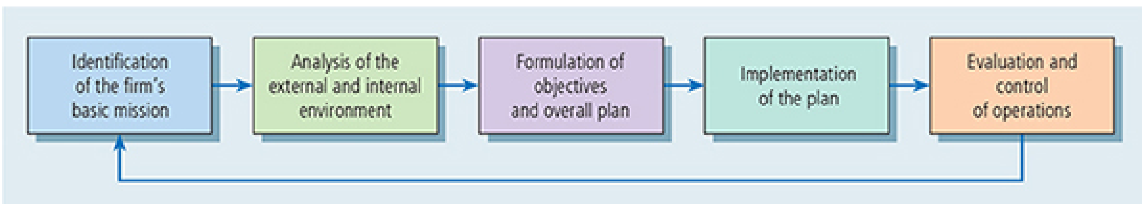

Figure 2.5 **The strategic management process in action**

Internal and external analyses will also help the MNE to identify both long-range goals (typically two to five years) and short-range goals (less than two years), which in turn shapes the firm's strategy. The plan is then broken down into major parts, and each affiliate and department is assigned goals and responsibilities. This begins the implementation process. Progress is then periodically evaluated and changes are made in the plan. For example, an MNE might realise that it must stop offering a particular good or service because the market is no longer profitable, or it might create a new product in order to take advantage of an emerging demand. Figure 2.5 describes the strategic management process.

A FRAMEWORK FOR GLOBAL STRATEGIES: THE FSA–CSA MATRIX

Although the eclectic paradigm and the FSA–CSA matrix serve similar purposes, the FSA–CSA matrix relies on only two blocks (absorbing the 'I' aspect of the eclectic paradigm within these two). Thus, the two basic building blocks of the FSA–CSA framework are firm-specific advantages (FSAs) and country-specific advantages (CSAs) (see Figure 2.6). Managers of most MNEs use strategies that build on the interactions of CSAs and FSAs. They do this so that they can be positioned in a unique strategic space.

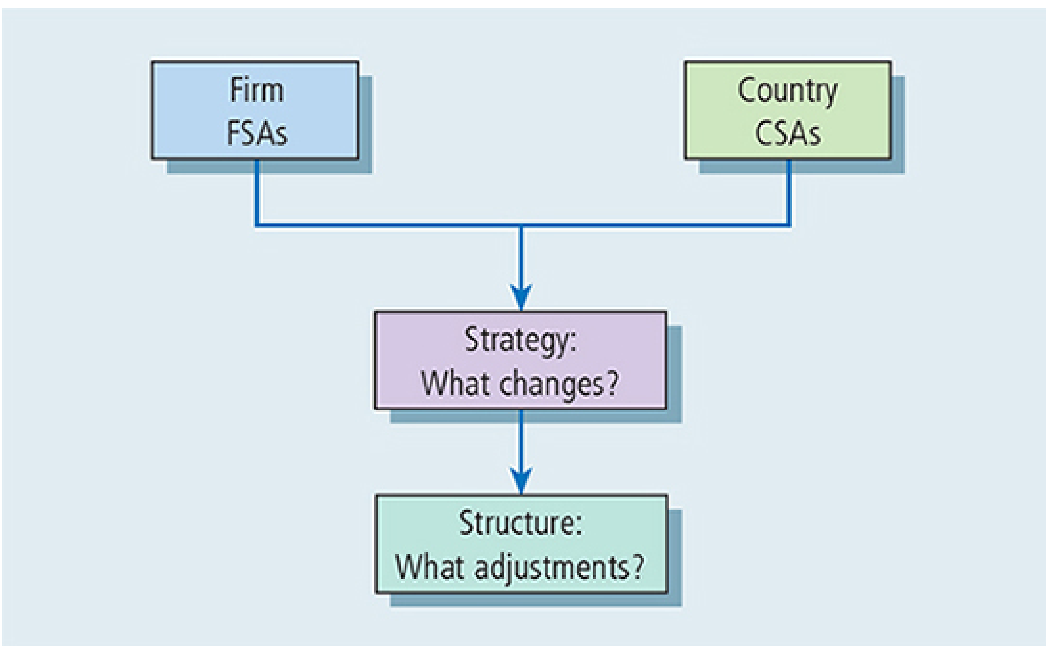

Figure 2.6 The basic components of international business

The CSAs represent the natural factor endowments of a nation; they are based on the key variables in its aggregate production function. For example, CSAs can consist of the quantity, quality and cost of the major factor endowment, namely resources. Using Porter's terminology, the CSAs form the

basis of the global platform from which the multinational firm derives a home-base 'diamond' advantage in global competition.[18] Tariff and non-tariff barriers to trade and government regulation also influence CSAs. Building on these CSAs, the firm makes decisions about the efficient global configuration and coordination between segments of its value chain (operations, marketing, R&D and logistics). The skill in making such decisions represents a strong, managerial FSA.

The FSAs possessed by a firm are based ultimately on its internalisation of an asset, such as production knowledge, managerial or marketing capabilities, over which the firm has proprietary control. FSAs are thus related to the firm's ability to coordinate the use of its advantage in production, marketing or the customisation of services.

The FSA–CSA matrix

To help formulate the strategic options of the MNE, it is useful to identify the relative strengths and weaknesses of the CSAs and FSAs they possess. Figure 2.7, the FSA–CSA matrix, provides a useful framework for discussion of these issues. The 'strength' or 'weakness' of FSAs and CSAs is a relative notion, depending on the relevant market and the CSAs and FSAs of potential competitors. A strong FSA implies that, under identical CSAs, a firm has a potential competitive advantage over its rivals.

Quadrants (or cells) 1, 3 and 4 correspond broadly to three generic strategies: cost leadership, differentiation and focus.[19] Quadrant 1 firms are generally resource-based and/or mature, globally oriented firms producing a commodity-type product. Given their late stage in the product life cycle, production FSAs flowing from the possession of intangible skills are less important than the CSAs of location and energy costs, which are the main sources of the firm's competitive advantage. Quadrant 2 firms represent inefficient, floundering firms with no consistent strategy, and no intrinsic CSAs or FSAs. These firms are preparing to exit or to restructure. Quadrant 2 can

also represent domestically based small and medium-sized firms with little global exposure. Quadrant 3 firms can generally choose to follow any of the generic strategies listed above because of the strength of both their CSAs and FSAs.

The quadrants in Figure 2.7 imperfectly correspond to the three ‘generic strategies’ utilised in the strategy literature: cost leadership, differentiation and focus. These firms basically follow a differentiation strategy. In quadrant 4 the FSAs dominate, so in world markets the home-country CSAs are not essential in the long run. Thus, these firms are following low-cost and price competition strategies.

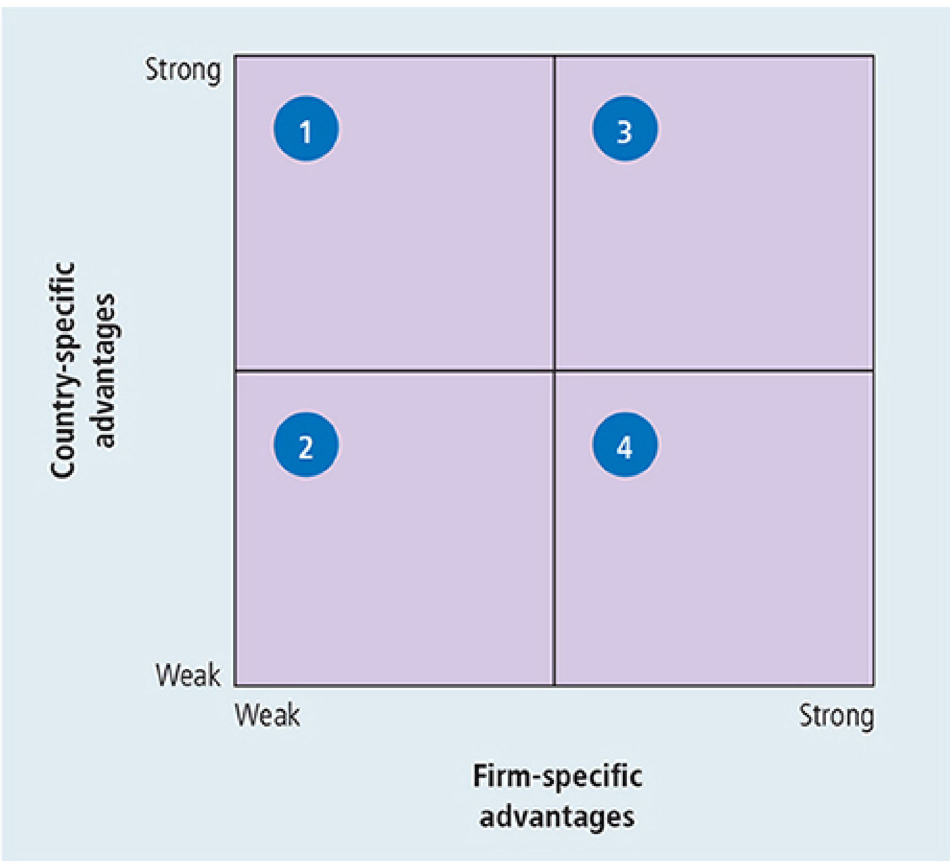

Figure 2.7 **The FSA–CSA matrix**

In terms of business strategy, quadrants 3 and 2 are unambiguous in their implications. A quadrant 3 firm can benefit from strategies of both low cost

and differentiation. Such a firm is constantly evaluating its production mix. As a product line matures and then declines, it eventually graduates to quadrant 2. However, by adopting new product lines, developing dynamic organisational capabilities, and maintaining an effective strategy, the firm can maintain its overall position in quadrant 3. In quadrant 2 there is no alternative but to restructure or to eventually leave the market.[20]

Quadrants 4 and 1 are credible positions for different types of firms. For instance, a quadrant 4 firm that has strong FSAs in marketing (customisation) can operate globally without reliance on its home-market CSA, or the CSAs of the host nation. For such a firm, quadrant 4 does not signal a CSA weakness; the CSA is not relevant. In contrast, quadrant 1 has mature multinationals or product lines determined more by CSAs than by FSAs. By improving potential FSAs in marketing or product innovation and increasing value added through vertical integration, the quadrant 1 firm can move to quadrant 3, where its profitability should be enhanced.

Although quadrants 1, 3 and 4 represent appropriate strategic positioning for some firms, there exists an asymmetry between quadrants 4 and 1. A quadrant 4 strategic choice may be a stable one for some firms; however, quadrant 1 firms should be able to aim for quadrant 3. The reason for this asymmetry is rooted in the fact that CSAs are for the most part exogenous to the firm, whereas FSAs are not. Even to the extent that CSAs can be influenced by government protection, there is always increased uncertainty associated with such strategies. For the firm in quadrant 4 already following an efficiency-based strategy there is no incentive, or need, to move to quadrant 3.

It is useful to note the following two points. First, if the firm has a-conglomerate structure, it would be more useful to situate each division or product line individually, recognising that different units of the diversified firm would use different generic strategies. Second, changes in the trading environment – such as the EU 1992 single-market measures, or the EU 1999 single currency, or the United States–Canada Free Trade Agreement and

NAFTA – will affect the relative CSAs of the firms. To the extent that CSAs are improved, the firms will tend to move to quadrant 3, and, to the extent that the CSAs are hampered, the firm or some of its product lines may move to exit, as in quadrant 2.

WHY FIRMS BECOME MNEs

Companies become MNEs (internationalise) for a number of reasons. There have been many attempts to create classification schemes of internationalisation motives. Of course, the most important motive that underlies all other motives is the profit motive. The purpose of the firm is first and foremost the generation of a greater return on its investment. The most complete set of motives was compiled by John Dunning in 1993, and these are listed in Table 2.4. Many of the firm's actions are also driven by the need to sustain and utilise its FSAs. At the same time, internationalisation is crucially driven by the need to engage with L advantages of a host country or location, or the FSAs of another firm located in the intended host location.

Table 2.4 Internationalisation motives

Types (adapted from Dunning, 1993)	Objectives/motives (inspired by and updated from Dunning, 1993)	The Cuervo-Cazurra et al. motives
Natural resource seeking	To acquire particular and specific resources of a higher quality at a lower real cost than could be obtained in their home country (e.g., physical resources, unskilled (or semi-skilled) labour, technological/managerial expertise, etc.)	'Buy better'
Market seeking	To supply goods or services to a particular country or region (from existing markets to new markets)	'Sell more'
Efficiency seeking	To rationalise the structure of established resource-based or market seeking investment in such a way that the investing firm can gain from the common governance of geographically dispersed activities (e.g., economies of scale and scope)	'Buy better' and 'Sell more'
Strategic asset seeking	To promote long-term strategic objectives – especially that of sustaining or advancing global competitiveness (e.g., -augmentation of global portfolio of physical assets and human competences, which they perceive will either sustain or strengthen their ownership-specific advantages or weaken those of competitors)	'Upgrade'
Escape investment	To escape restrictive legislation, institutional voids, or macro-organisational policies by home governments (e.g., round-	'Escape'

	tripping investment, escaping from high levels of taxation or austere environmental regulation, etc.)	
Trade-supportive investment	To promote and facilitate the exports and imports of goods and services from the investing (or other) firm	'Buy better' and 'Sell more'
Finance-supportive investment	To support and assist in the purchasing of foreign-produced goods and services from investing (or other) firm To establish domicile in specific location for regulatory and tax reasons	'Buy better' and 'Sell more'
Management-supportive investment	To support the control and coordination function on behalf of MNE headquarters (e.g., regional office, branch offices)	'Upgrade'
Passive investment	To arbitrage by buying and selling firms or assets with some involvement of direct managerial inputs (e.g., private equity capital firm, asset stripping, etc.)	'Buy better' and 'Sell more'

Source: A. Cuervo-Cazurra, and R. Narula, 'A set of motives to unite them all? Revisiting the principles and typology of internationalization motives', *Multinational Business Review*, vol. 23, no 1 (2015).

There is a crucial difference between the strategy of a firm, and its motivation to internationalise.[21] It may be a firm's strategy to do certain things, including internationalise, but to decide on a specific location requires the logic of location advantages to be included in the decision. The motivation to internationalise implies that the MNE seeks to utilise its FSAs in conjunction with location-specific assets.[22] Figure 2.8 summarises the options available.

The firm is intent on seeking to 'squeeze' or exploit its existing FSAs as efficiently and as thoroughly as possible: in other words, to be *asset exploiting* in nature. However, as discussed in greater detail in Chapter 3, it is the very nature of FSAs that their value as a mechanism from which to derive income declines over time. That is, there are very few FSAs that are as valuable in ten years' time as they are today. This may be because other firms introduce products and services that compete directly, or create new products and services that supersede them. In other words, the FSA of a firm will become less valuable over time as a profit-generating mechanism, and the firm must seek to augment its existing assets, or develop and acquire new FSAs to supplement its older ones. Thus the second broad category of motives is associated with *asset augmentation* (Figure 2.8).

Under these two broad themes comes a variety of motivations (Figure 2.8). Firms may undertake *market-seeking internationalisation* because they wish to 'sell more'. Firms may wish to capture economies of scale, thus expanding internationally. Many MNEs have targeted the United States because of its large population and high per capita income. Other firms sometimes need to diversify themselves in the face of the risks and uncertainties of the domestic business cycle. By setting up operations in another country, MNEs can often diminish the negative effects of economic swings in the home country. This has been widely done by Japanese MNEs, for example, which have found that, while their home economy has been in an economic slump since the 1990s, their US and European operations have done quite well.

Firms can internationalise to ensure access to important inputs to their activities by engaging in *resource-seeking investments*, creating 'captive' input suppliers. This helps reduce the risk of opportunistic behaviour by arm's-length suppliers, and the volatility of the market. In other words, they learn how to 'buy better'. These resources can include land, extractive mining assets, unskilled (or semi-skilled) labour, technological/managerial expertise, etc.

Firms can internationalise to be *efficiency seeking*. By setting up operations close to the foreign customer, these firms can eliminate transportation expenses, avoid the overhead associated with having intermediaries handle the product, respond more accurately and rapidly to customer needs, and take advantage of local resources. This process, known as internalisation of control within the MNE, can help to reduce overall costs. Firms can rationalise the structure of established resource-based or market-seeking investment in such a way that the investing firm can gain from the common governance of geographically dispersed activities (e.g., economies of scale and scope).

Due to protective devices such as tariff and non-tariff barriers it may make sense to serve the market by FDI rather than through exports. The EU provides an excellent example. Firms outside the EU are subject to tariffs on goods exported to EU countries. Firms producing the goods within the EU, however,

can transport them to any other country in the bloc without paying tariffs. This may be considered *trade-supportive* internationalisation.

Brexit and apartheid: The logic of ‘escape’ as a motive for internationalisation

It is in the nature of economic actors to seek to reduce uncertainty as much as possible. The Brexit debacle, with the UK trying to determine a new relationship with the European Union after the Brexit referendum is an excellent example of this. In the two years after the Brexit referendum, the British government has failed to determine the UK’s trading and investment relationship with the rest of the EU. Firms are unclear whether they will face investment and trade barriers after Brexit, and many have moved some of their activities abroad. A popular destination has been Ireland (especially for banks), but Germany and the Netherlands have also been popular alternatives. For manufacturing firms, the danger that their complex intra-European supply chains will be disrupted by the reintroduction of tariffs and customs controls, which rely on just-in-time delivery of components and sub-assemblies.

During the 1970s and 1980s, a similar exodus of firms occurred from South Africa, due to the international sanctions against the Apartheid regime in South Africa. Foreign firms disinvested from South Africa, while also accelerating the internationalisation of South African MNEs, many of which moved their headquarters abroad. Examples are South African Breweries and Investec bank.

Firms may make *‘escape investments’* because the home market is unstable, or increasingly risky because of political, social or economic changes. A considerable number of emerging country MNEs seek to avoid institutional voids. That is, they seek to relocate their activities to places where the formal and informal institutions are more stable. HSBC began life as a Hong Kong-based bank, but due to the uncertainty of Hong Kong’s status prior to the 1997 handover to China, it decided to move its headquarters and centre of its operations to the UK.

It is important to distinguish escape investments from flight capital. *Flight capital* refers to investments whose primary purpose is to move financial resources out of a country that is considered risky, to another which is less

risky. It is about financial movements of capital, and although these movements may be done through (and by) firms, the objective is similar to portfolio investments (discussed in Chapter 1).

Asset-augmenting internationalisation is also referred to as *strategic asset-seeking* FDI in many academic texts. It describes an important reason for MNEs to internationalise, referring to investments by MNEs that are intended primarily to create learning opportunities that enhance their firm-specific advantages. It involves the active augmentation of existing ownership advantages through R&D, or through the acquisition of FSAs as part of a cross-border M&A. However, it is not always the case that the acquiring firm has the capacity to internalise and efficiently utilise such knowledge. Asset augmentation is forward looking (and aspirational), and more than any other foreign activity of an MNE it depends upon the correct appraisal of the assets of other external actors. It is crucially dependent upon the existing FSAs of the MNE because the purpose is to 'upgrade' these FSAs of the firm through internationalisation.[23] Upgrading is not at all straightforward, as we shall discuss in Chapter 3.

Growing through strategic asset-seeking investments?

Emerging country MNEs – especially those from China and India – have shown a string propensity to expand through M&A for the purposes of expanding their FSA portfolio. In practice, firms without substantial existing FSAs and innovative capacity are unlikely to be able to integrate acquired assets successfully. Besides, it is not entirely clear whether an FSA-through-acquisitions approach is cost-effective, with hubris and national pride affecting acquisition decisions rather than strategic or economic decisions. Assets-by acquisition assumes that the FSA of the acquired firms are in principle immediately made available by the acquired, and accessible by the acquirer. Even in the most advanced MNEs, knowledge does not transmit freely, and the FSAs of a parent are not necessarily available to all its subsidiaries, and vice versa (Narula, 2014).

Many EMNEs wisely avoided trying to integrate their foreign acquisitions, thereby avoiding this problem. Chittoor and Jena (2013) found that the majority of Indian acquisitions did not integrate the acquired firm into the parent company, allowing the acquired firm to maintain a high degree of organisational and managerial autonomy.

A single MNE may engage in multiple motivations in a given location. Motives, of course, are hard to determine accurately because firms are not willing to admit why they have engaged in a certain activity, since it will reveal their strategy to the public. Motives are always evolving, like strategies, because they are aspirational, and when they fail to produce the desired outcome, they require a revision in motivation, if not also in strategy. But crucially, they are also dependent upon actors outside the firm for their successful implementation. These actors are not passive, and also have their own motivations which are also evolving.[24] Relationships are rarely equal, and this can mean that firms with a weaker position (such as supplier firms to large MNEs) have their internationalisation strategies dictated to them by their customers or, indeed, by their competitors (proactive vs. reactive motives).[25]

Motives require information and the willingness of other actors to cooperate, which means that firms are constantly reconsidering their actions. HSBC may have withdrawn from being a Hong Kong (and Asia-centric) bank in the 1990s, but since 2015 it has been reconsidering this move, partly in a reaction to Brexit (its global HQ is now London), and the growing dominance of Asia as a growth market. There have been rumours that HSBC has been actively discussing the possibility of strategic reorientation to its pre-1997 roots as an Asia-centric bank.

It is also worth remembering that MNEs do not always function as a single centrally managed firm in which all the parts are following the same strategy. The strategy of two subsidiaries within the same MNE can differ, and the motives of the headquarters in undertaking certain actions may not be supported by the foreign subsidiary.[26] That is, there are differences in motives between units of the same MNE. For example, consider Coca-Cola's inter-subsidiaries competition in Spain. The Spanish subsidiary represented the second-largest agribusiness company in Europe, after Germany, and saw its sales drop dramatically in 2009. Rather than finding it had lost its sales to competitors from outside the company, the subsidiary discovered sales had dropped due to cheaper imports of Coca-Cola bottles from Poland and Egypt. Though sometimes a preferred strategy, Executives in the US head office had an interest to resolve the inter-subsidiary competition as it was mainly the distributors who benefited from it, rather than Coca-Cola itself.

Over the last 30 years, MNEs have become increasingly sophisticated in managing and integrating activities across borders, and even relatively new and smaller MNEs are organised to maximise cross-border efficiencies and take advantage of the economies of common governance. Today, MNE operations increasingly tend to involve multiple motivations simultaneously.[27]

Firms also become MNEs in response to increased foreign competition and a desire to protect their home market share. Using a follow-the-competitor strategy, a growing number of MNEs now set up operations in the home

countries of their major competitors. This approach serves a dual purpose: first, it takes away business from its competitors by offering customers other choices; and second, it lets competitors know that, if it attacks the MNE's home market, it will face a similar response. This strategy of staking out global market shares is particularly important when MNEs want to communicate the conditions under which they will retaliate.

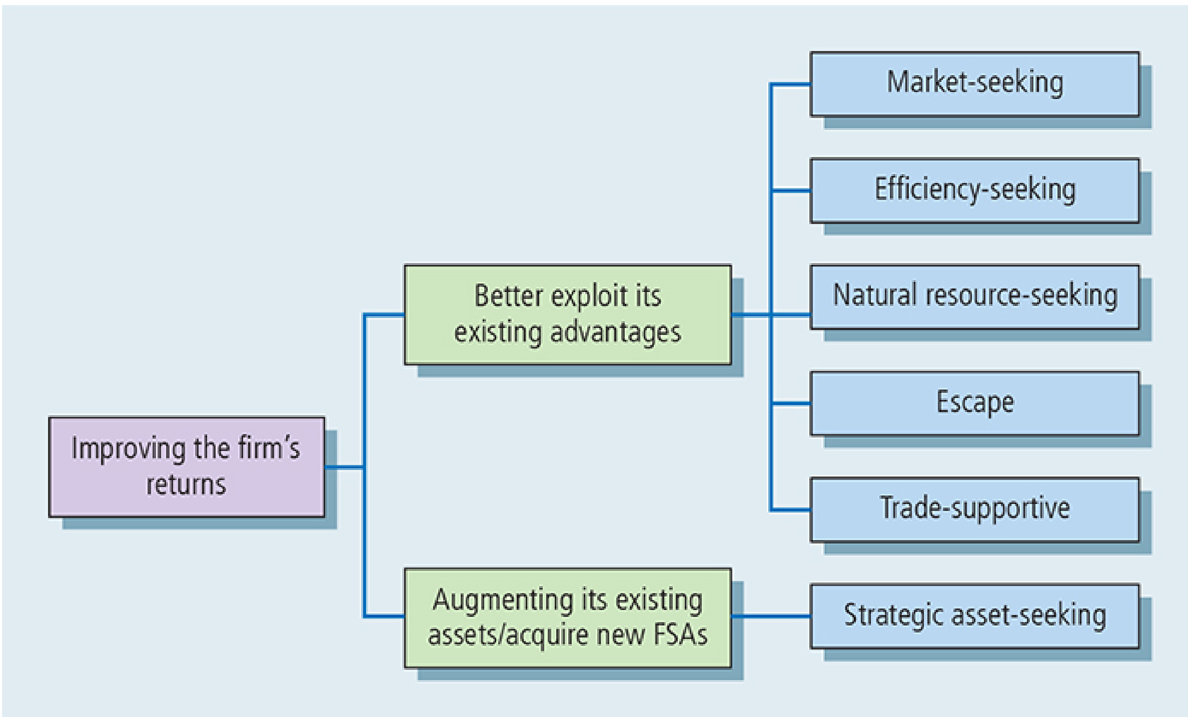

Figure 2.8 **The motives of internationalisation: a decision model**

How do firms engage in international activities?

Not all international business is done by MNEs. Indeed, setting up a wholly owned subsidiary is usually the last stage of doing business abroad. Why is it so? Why do firms wait to set up wholly owned subsidiaries and become MNEs?

Figure 2.9 outlines the typical process (or stages) by which a firm producing a standardised product will seek to develop its interdependencies with foreign markets. While this is apparently a generalisation, as firms ultimately make

decisions depending on their particular circumstances (i.e., industry, business model, etc.), this process is important because it is based on how the firm perceives risk and how it deals with it. In this process of internationalisation, the firm *gradually* and *incrementally* develops its interdependencies with foreign markets because of the *liability of foreignness* – the inherent disadvantage that foreign firms experience in host countries due to their non-native status.[28]

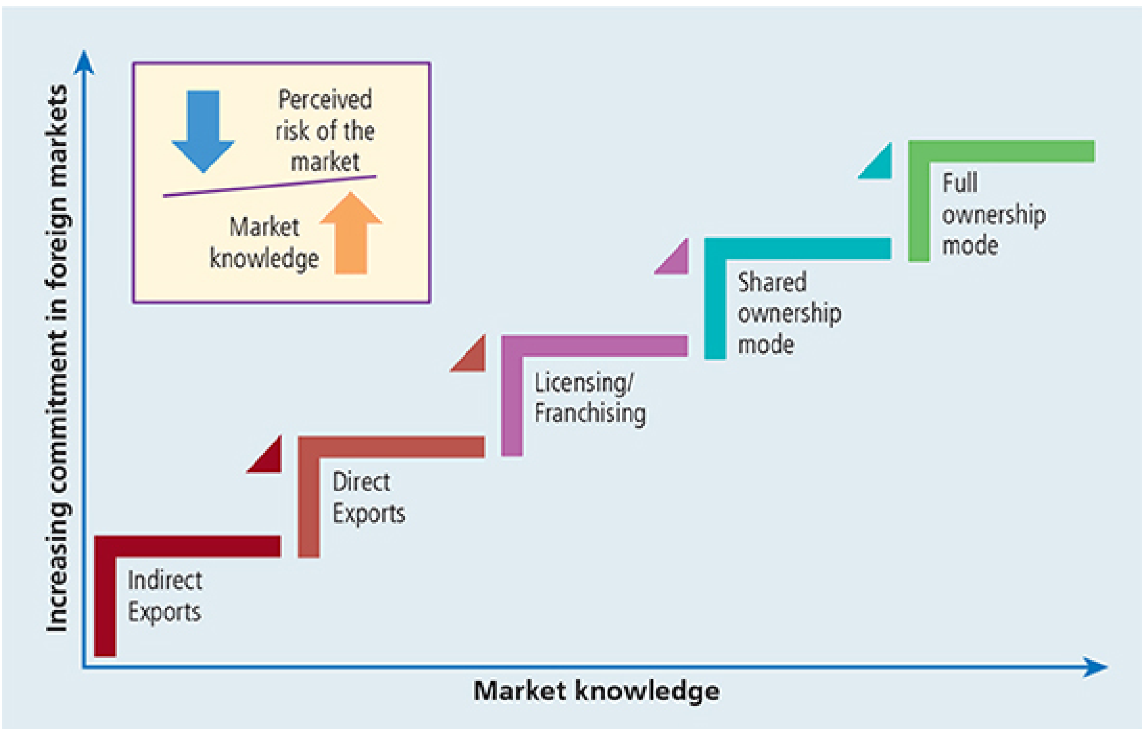

Figure 2.9 The internationalisation process of the firm

The firm regards foreign markets as risky due to the fact that they involve a number of differences that are unknown or uncertain to the non-native firm. Foreign markets may have different *rules of the game* because they are governed by different formal and informal institutions. Thus, the (foreign) firm that is not well acquainted with the institutions in the host country is likely to face significant disadvantages (vis-à-vis a local firm) of doing business in host markets (i.e., higher transaction costs). To offset such disadvantages, the investing firm often has to deploy considerable resources and capabilities to

engage in the foreign market. In general, firms are risk-averse. Therefore, firms often take an incremental approach to internationalisation. This is known as the 'Uppsala model'[29] because it was initially developed by scholars at Uppsala University in Sweden. This allows them to develop their knowledge of the host market at a gradual pace. The main argument of this model is that firms *incrementally* increase their commitment to foreign markets by gradually acquiring knowledge about foreign markets and operations through experience. Therefore, the Uppsala model shows that the firm's internationalisation process is path dependent. *Path dependence* is the process where the accumulated knowledge from the firm's past international experience helps direct the firm's future trajectory.[30]

As shown in Figure 2.9, the gradually increasing approach to internationalisation is shaped by the degree of *market commitment* the firm wishes to make, and the stock of *market knowledge* that the firm has of the host market. Market commitment is dependent upon the amount of resources devoted to enter the foreign market. By investing in a foreign market it is making a commitment, and the firm makes a deliberate choice in deciding its level of commitment.

Building up market knowledge is also a gradual process, shaped by experience, and what is known as *learning-by-doing*. Naturally, the commitment a firm makes to a foreign market is a function of its market knowledge. Initially firms usually perceive a high risk of making a commitment to foreign markets due to their lack of knowledge. Thus they typically start with low commitment to host markets, often using the services of specialists in local markets outside the firm. The accumulation of market knowledge will alleviate the perceived risk of the foreign market and gradually enable firms to make greater commitment to it (and develop deeper interdependencies with local actors). As illustrated in Figure 2.9, firms tend to increase their interdependencies with foreign markets in inverse proportion to

perceived risk (blue-coloured section), which gradually decreases over time with the increase of *market knowledge* (orange-coloured section).

When the firm decides to enter a new market, it may want to avoid the risks of high commitment to unknown (foreign) markets by arranging non-equity-based agreements such as *licensing* or *franchising*.

Instead of licensing, the firm may see the potential for extra sales by exporting its products to foreign markets. When the firm has little knowledge of the foreign market, it may use a *local agent or distributor*. In this stage, the firm often uses exporting as a 'vent' for its surplus production. Exporting has the benefit of requiring no long-run commitment to the international markets. As the firm acquires market knowledge it may set up its own local sales or marketing subsidiaries. This may be a *wholly owned subsidiary*, controlled by the investing firm. It may be a *joint venture* with local firms, in which the firm has a partial ownership (and partial control). Both of these options are *equity modes of governance* (typically involving FDI) that involve relatively large commitments to the foreign market. This is distinguished from *non-equity modes of governance* such as *licensing*, *franchising* and *exporting using agents*. Where exports become a significant part of the firm's sales, it will often set up a separate *export department* to manage foreign sales and production for such markets. Product design and the production process itself may also be modified to tailor products for export markets.

After the firm has become more familiar with the local market and accumulates more market knowledge, it may begin to locate higher value-adding activities such as production. This indicates a growing commitment to, and deeper interdependencies with, the foreign market. Even so, it is likely that such expansion will also be gradual. Initially, it may start with *local assembly and packaging* of its product lines, but later it may move towards deeper interdependencies by locating more strategic activities such as headquarter functions and R&D.

The Uppsala model is more complicated than it seems at first glance. Like all generalisations, it relies on simplifications. Not all firms necessarily follow the same sequence, or always begin the internationalisation process with licensing or exporting. In reality, the process of internationalisation and foreign entry is sufficiently complicated to depend on a careful weighting of many firm-specific and location-specific factors. The Uppsala model is not really about stages. It is built around the concept of learning and gradual evolution. Firms go from the familiar to the unfamiliar slowly and gradually, *if* they have a choice in the matter. Likewise, the Uppsala model also argues that (all else being equal) firms will decide where to go following a similar logic of incrementalism. The evidence indicates that, left to their own measures, firms conventionally prefer to engage with nearby countries first because these are likely to be similar to their home country – because they will have a smaller liability of foreignness in such locations. As they develop more confidence in internationalising, they then further expand into more remote countries. Low-commitment entry modes, including joint ventures and alliances, rather than M&A or wholly owned greenfield investments, were seen as necessary stages in the learning process, to reduce risk and uncertainty.

'Neighbouring' countries does not only mean neighbouring in terms of geographical location, but also in terms of perceived similarities between the host and home country in a number of factors, including, religion, education, culture, language, industry development and political systems. These factors make up the multidimensional concept of *psychic distance*, which is the perceived difference between two nations.[31] An example concerns the UK and the US. Although they are not neighbouring countries, they share similar culture, language, business customs and regulation. As a result, a UK firm will perceive it to be easier to do business in the US than in China, where there is a larger distance between the countries in terms of language, business customs, culture and regulation. Therefore, according to the Uppsala model approach,

the UK firm is likely to enter the US market before entering the Chinese market.

There are many caveats to such a general model, which people often take literally. There are industry-specific cases where low-commitment modes such as exporting are simply not an option. For instance, in the case of many service sector industries such as banking, finance and insurance, foreign firms are required by host country regulators to establish a local presence as a condition for market access. In other instances, host country governments may impose punitive import duties and other tariff and non-tariff barriers to force firms to make a significant market commitment, and require that the foreign firm creates either a wholly owned subsidiary or a joint venture (for instance, in China).

That firms skip the exporting stage altogether and go immediately for FDI and a substantial local presence is not new. There are sectors where high transportation costs have always made exporting expensive (cement), while in others a local presence is necessary because of specific local consumption patterns and tastes, such as food products and beverages, because firms need to develop specific customised products for that market. In other cases, the firm may find that non-equity modes of governance do not sufficiently protect their FSAs from misuse by third parties. In such cases, firms choose to directly engage in full internalisation by establishing a wholly owned subsidiary.

Psychic distance paradox

While, on the one hand, many researchers have found that firms find it easier to learn and have greater success when entering a foreign market where there are similarities between the two countries, on the other hand, research by O'Grady and Lane in 1996 showed the complete opposite. They concluded that 'starting the internationalisation process by entering a country psychically close to home may result in poor performance and, possibly, failure'. The reason for this paradox is that the perceived familiarity led firms to underestimate the

differences between the domestic market and the foreign market. Indeed, O'Grady and Lane (1996) showed that Canadian firms were performing poorly in the US market for that very reason.[32]

✔ Active learning check

Review your answer to Active Learning Case question 3 and make any changes you like. Then compare your answer to the one below.

3 Why did Starbucks fail in Australia?

The main reason why Starbucks failed is because it underappreciated the differences between US consumers and Australasian consumers. Interestingly, Starbucks, in the past, has been more aware of the differences between its home market and the host country (such as when it expanded into China), and adapted its strategies and products accordingly. This is an example of a psychic distance paradox: with the US and Australia on the face of it having similar characteristics (e.g., language and culture), Starbucks underestimated the difference between the two countries and failed.

Distance and foreign entry locations: the CAGE model

In addition to strategic goals, when making the where to enter decision firms must also consider cultural, institutional and other differences between the home and the host country. While it is widely agreed that distance matters in international business, there has been less consensus on how to adequately capture distance in a single metric. Arguably, Ghemawat's (2001, 2017) CAGE model (see Figure 2.10) is the most accessible and widely adopted method of measuring distance in international business today. Ghemawat argues that there are four types of distance – cultural, administrative (institutional), geographic and economic – as outlined below.

- **Cultural distance** is defined as the difference between two cultures along some identifiable dimensions. To capture the cultural dimension of distance in international business, it is common to draw upon the established cultural frameworks such as those of Hofstede, Trompenaars and the GLOBE project. However, cultural distance may also be

associated with related factors such as different languages, ethnicities or religions.

- **Administrative distance**, which we can also refer to as institutional distance, is the extent of similarity or dissimilarity between the regulatory, normative and cognitive institutions of two countries. For example, firms from common-law countries are more likely to share commonalities with other common-law countries. A shared currency, a colony–coloniser relationship or membership of the same trading block are other examples of factors that are known to significantly reduce administrative distance.
- **Geographic distance** is the extent to which two countries are located physically close to each other. In its simplest form, this can be measured as the shortest distance between two countries on a map. However, there are also other ways of capturing this dimension, such as travel distance, time zone difference, climate or shared land/sea borders.
- **Economic distance** refers to the difference in the level of economic development between two countries. This is another important dimension of distance as economic development is associated with crucial enabling factors in international business, such as the availability of highly skilled labour and high-quality infrastructure.

	Cultural Distance	Administrative Distance	Geographic Distance	Economic Distance
What creates distance?	• Language differences • Ethnicity differences and lack of social and local networks • Different religious backgrounds • Potential lack of trust • Differences in values, norms, and habits	• Potential lack of colonial ties • No existing regional trading block • No common currency • Political hostility and difficult past	• Physical distance (e.g. in miles/km) • No shared borders • Different time zones • Different climates	• Differences in monetary wealth • Differences in capital markets • Differences in GDP per capita and living costs • Differences in physical infrastructure • Differences in sourcing talent
What industries or products are affected by distance?	**Cultural differences are especially important when:** • products heavily rely on linguistics (e.g. TV, Netflix) • products are subject to consumers' cultural or national identity (e.g. food) • product characteristics vary in terms of size and packaging • products are defined by country-specific quality associations (e.g. wine)	**Government involvement affects industries characterised by:** • sellers of staple goods (e.g. electricity) • producers of pharmaceuticals • important (i.e. large) employers • national champions (e.g. airlines) • importance to national security (e.g. telecommunications, military) • high sunk costs (e.g. infrastructure)	**Geography is highly important when:** • products are sold in bulk at a low unit cost (e.g. cement) • products are fragile or perishable (e.g. glass or meat) • communication and interaction are highly relevant (e.g. professional services) • there is a need for local supervision and operational complexity is high	**Economic differences matter the most when:** • income levels impact levels of demand (e.g. cars) • economies of standardization or scale are limited (e.g. cement) • labour costs differ substantially (e.g. fashion) • distribution and business systems vary (e.g. insurance)

Figure 2.10 The CAGE model

Source: Created by author and adapted from Ghemawat (2001, 2017).

ENTRY MODES

When the firm decides to enter a new market, the first step is to decide whether it will opt for non-equity or equity entry modes. At the first stage, it may want to avoid the risks of high commitment to unknown (foreign) markets by arranging non-equity modes, such as exports and contractual agreements, and later move to equity modes (FDI), such as partial or full acquisition, which involve higher commitment to the foreign markets and often require higher knowledge or experience.

Non-equity entry modes

Exports are the most common or basic entry mode, often used by firms as a 'vent' for their surplus production. Exporting is considered a potential source of extra sales, so in most cases the foreign markets are considered as an extension of the home country operations, providing economies of scale to firms that concentrate the production in the country of origin. Firms can opt for *direct* or *indirect exports*. In the latter case, firms may use a local agent or distributor to enter a particular market. By choosing this option, they do not need to be directly involved in the export process activities, such as shipping logistics or arranging appropriate distribution channels. However, two drawbacks may emerge. First, due to the minimal involvement in the process, firms will not learn from the experience of operating in foreign markets. Second, there is little or no control over products/services distribution.

Direct exports allow direct control of the distribution, branding and pricing of products and services. Besides, it provides high involvement in the exporting process, allowing the understanding of consumers' needs and the identification of new opportunities. However, in comparison to indirect exports, this option has some drawbacks, such as higher costs, the need for a

higher knowledge of foreign markets, and the liability of foreignness. Being a foreign company operating in the host country, the firm may face trade barriers from host country governments as well as difficulties in acceptance by host country customers.

Another non-equity mode of entry is via *licensing* or *franchising* agreements. Licensing is a contractual arrangement in which one firm (the licensor) provides access to some of its proprietary assets, such as patents, trademarks, or technology, to another firm (the licensee), in exchange for a fee or royalty. This fee often involves a fixed amount upon signing the contract and then an additive amount of 2–5 per cent on sales generated by the agreement. A typical licensing contract will run for a fixed period of time (usually from five to seven years) and be renewable at the option of either or both parties. Franchising agreements are essentially similar to licensing agreements; however, they are typically used in the service industries.

The main benefit of non-equity agreements is that they require low initial investment and, therefore, risk only low financial losses if the foreign operations do not succeed. Moreover, the contracts may contain extremely detailed description of the licensee's or franchisee's obligations and conditions. Nonetheless, licensing and franchising agreements are more suitable for standardised products, services or processes, where there is no risk of dissipation of the firm's technological or managerial advantages.[33] Indeed, one of the drawbacks is the high level of knowledge transfer, allowing not only the dissipation of the firm's FSAs, but also the development of competitors. The second drawback is low involvement in the daily licensee or franchisee operations, which may lead to limited control over marketing and production.

All the entry modes presented above are non-equity options. In most cases, non-equity entry modes involve less commitment to host countries, diminishing the uncertainty experienced when an enterprise is entering an unknown market. Indeed, when enterprises have low knowledge of the foreign market, non-equity entry modes are usually the less risky option. However,

they can be considered an inefficient strategy when firms need to transfer intermediate goods across borders, because of market imperfections. Furthermore, they often involve less control of the firm's ownership, exposing the enterprise to the risk of creating competitors.

Equity entry modes

After the firm has become more familiar with the local market, some of the uncertainty associated with foreign involvement will have been overcome. The final stage of foreign involvement comes when the firm has generated sufficient knowledge of the host country to overcome its perception of risk. Because it is more familiar with the host country environment, it may now consider a foreign direct investment (FDI) activity. In this, it produces the entire product line in the host country.

The decision to invest in equity-based modes depends on several factors concerning the host and home country features. For instance, enterprises are more likely to invest in equity-based projects in host countries where governments offer policies that favour foreign direct investment. In a similar way, an equity mode is preferred when the host country's risk factors are perceived as low. FDI involves both contextual and transactional risks. Contextual risks are related to uncertainties about the foreign market environment, such as the instability of political systems, currency convertibility, price control and the risk of intervention or expropriation. Transaction risks involve the risk of opportunistic behaviour by local firms.[34] The perception of risks differs across firms from different countries, mainly because of cultural distance and managers' previous experience. However, the perception of risk tends to decrease when (foreign) market knowledge increases.

The equity modes can be classified into two types, shared ownership and full ownership. *Shared ownership* comprehends agreements between firms in which they have partial ownership, such as *international joint ventures*. An

international joint venture is an agreement between two or more partners that involves setting up a new business entity overseas. It arises when two or more enterprises possess assets they want to combine, but assets both from the enterprise that is investing abroad and from the foreign enterprise are hard to sell or transact. For instance, when the efficient production of a product requires the combination of resources from enterprise X (local) and enterprise Y (foreign), but the transaction of the resources/knowledge is non-marketable due to market imperfections, such as high bargaining and information costs, the companies may engage in a joint venture. When the assets from only one company (in this case, enterprise X) are hard to sell, the best option is licensing (non-equity mode): that is, enterprise Y licenses enterprise X.[35] We explore strategic alliances and international joint ventures later in this chapter.

The benefits of this type of FDI are cooperation with partners that possess complementary resources and the sharing of risks and costs. Moreover, joint ventures are usually encouraged by governments. However, this type of agreement has a high rate of failure,[36] mainly due to conflicting goals, disputes about control, high instability and poor decision making.

International joint ventures will be preferred to full acquisitions whenever firms want to combine resources, but the acquisition of the firm that possesses complementary resources (in this case, enterprise Y) is not possible due to legal barriers or market imperfections. They are also preferred when the complementary assets that enterprise X needs from enterprise Y are hard to separate from the assets that are not needed.

The last entry mode option is the *full ownership* of a subsidiary in a foreign country. Firms have the choice to set up subsidiaries through greenfield investment or acquisition. *Acquisition* will be the preferred choice whenever a firm wants to access assets that are embedded in another firm and the acquisition of the firm that possess the needed assets is legally possible, the market is efficient (i.e., the asset prices resemble their true value), and it does not involve high management costs.[37] The management costs depend on the

compatibility between the resources of the acquirer and the acquired firms, as well as the earnings expectation after the payment of the acquisition costs. Acquisition is a faster way to enter foreign markets than greenfield investment, however it involves drawbacks. Acquisition is not always allowed, either by government barriers or by legal restrictions, and acquisitions may be considered to lead to ill will in some contexts. Moreover, the post-acquisition integration may be problematic.

A *greenfield* investment involves the establishment of a completely new business unit in a foreign market. This will be the preferred option whenever the integration of acquisitions is too costly and the assets needed can be accessed without the acquisition of an enterprise: for instance, when a company wants to access a skilled labour force available in a foreign country. The advantages of greenfield investment are that the enterprise has full control over the foreign operations and the firm’s ownership, and the management of the unit is easier because it does not involve integration problems. The drawbacks are the high cost and the low speed involved in the establishment of new facilities from scratch. Furthermore, this type of investment usually requires high market knowledge and previous international experience. Figure 2.11 shows a summary of the advantages and disadvantages of each entry mode option.

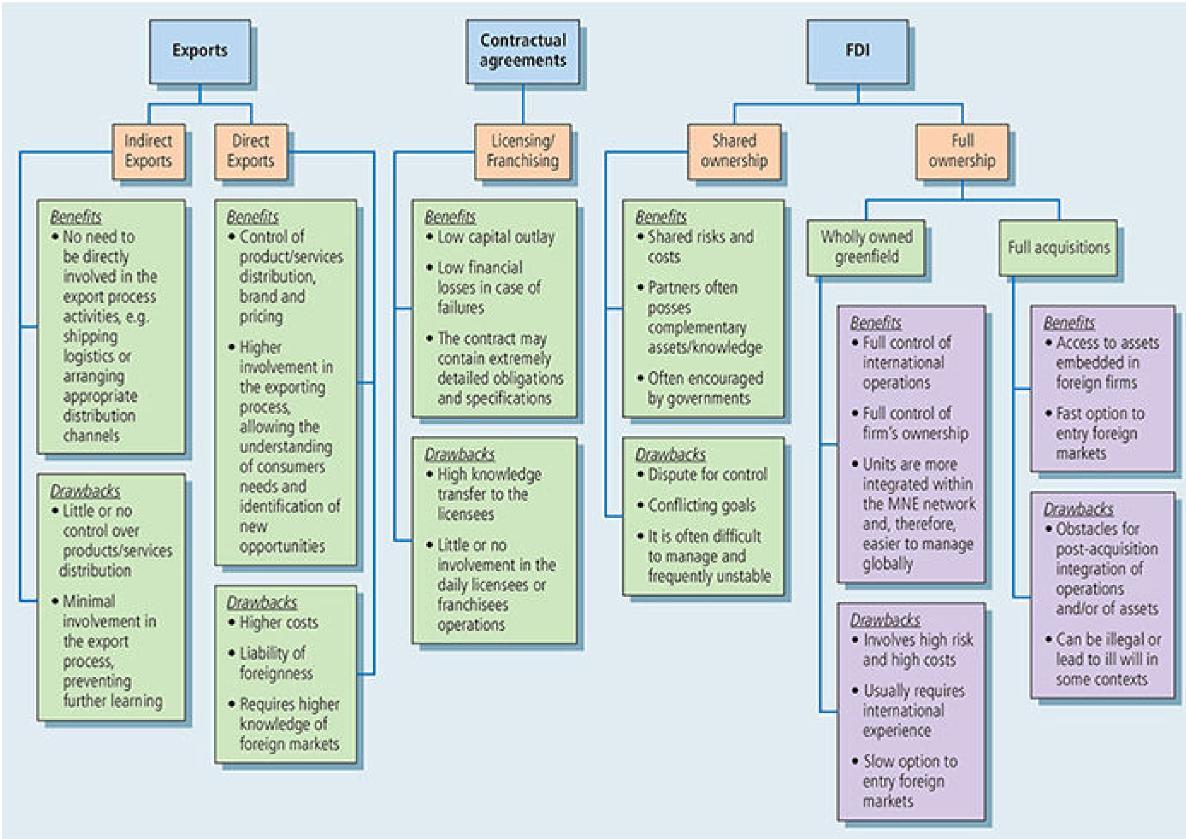

Figure 2.11 Entry modes: benefits and drawbacks

On the flip-side, firms may choose *not* to proceed to higher degrees of foreign market commitment, and continue to service foreign markets by exporting, licensing or franchising. This is especially so for SMEs, which may simply not have the resources to engage in FDI. For firms of all sizes, scale economies in production may already be achieved at home (or in another location). Take the automobile sector. Optimal economies of scale typically come from an annual capacity of over 150,000–200,000 units a year. Smaller markets may be better served by exports rather than investing in low-scale production.

Collaborative agreements/strategic alliances

It is no accident that the past few decades have seen a rapid growth in collaborative agreements between firms. This trend is particularly evident in

those industries where consumption patterns are more homogeneous across countries, and which show a high level of capital intensity as well as knowledge intensity in terms of investment in innovation and technology.[38]

Cooperative arrangements have proven to be supplementary to hierarchical, fully internalised activities (such as those discussed above) within the boundaries of a vertically or horizontally integrated firm.[39] They are not entirely new either, as economic actors have relied upon cooperation to gain competitive advantage since time immemorial. Nonetheless, collaboration is now an especially large and pervasive phenomenon, and the increased use of collaborative agreements has been observed among all firms irrespective of their size and country of origin. Firms have always needed external partners (suppliers, competitors, customers, universities, technological research centres or institutes) to collaborate with on different, specific activities along their value chain, but the extent to which firms in the twenty-first century systematically exploit cooperative networks and agreements is quite breath-taking.

Nowadays, knowledge-intensive firms from both advanced and developing countries are globally dispersing and disintegrating their value chains to control costs and leverage their capabilities. Through strategic alliances, firms have found a way not only to be more efficient or flexible, but also to benefit from the distinctive capabilities of specialised partners located worldwide, even in emerging countries.

Cooperative agreements cover a wide array of different activities, as Figure 2.12 illustrates.

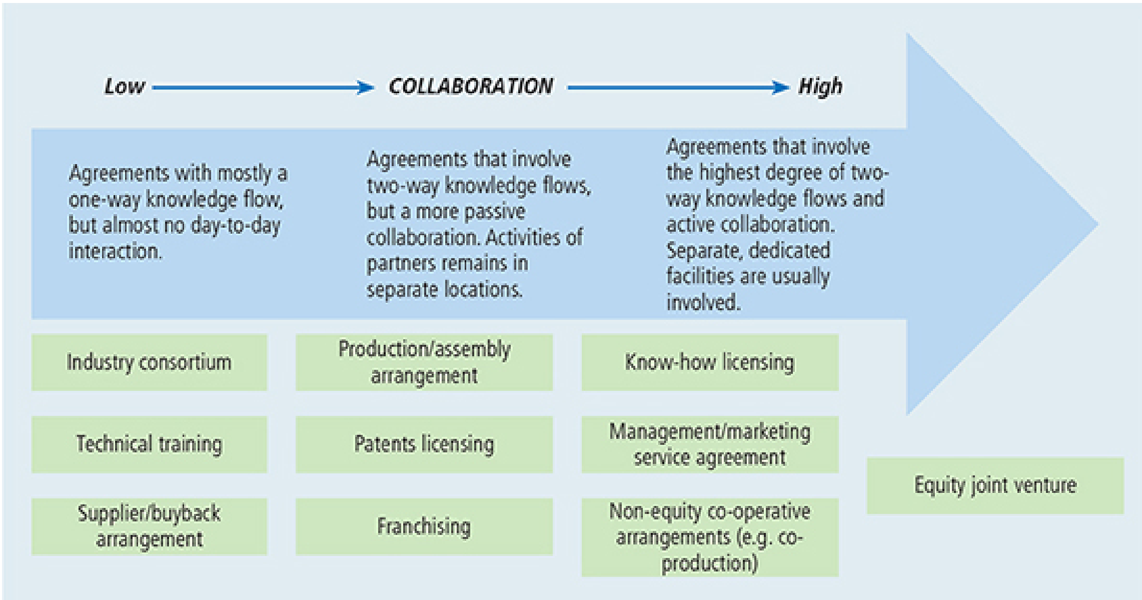

Figure 2.12 Organisational modes of cooperative agreements

Source: Adapted from Narula and Martinez-Noya 2014; Inkpen, 2009: 390.

Horizontal versus vertical cooperation

It is important to distinguish between horizontal cooperation and vertical cooperation. Each has different primary motivations. *Horizontal cooperation* occurs among enterprises operating in the same industry, engaged in roughly the same kinds and types of value-adding activities. The opportunities for economies of scale and scope are here maximised, but there is also the possibility of conflict and leakage of intellectual property from one partner to the other. The cooperation between two biotechnology enterprises or between a human biotechnology enterprise and a pharmaceutical manufacturer would be considered a horizontal alliance. These are strategic in nature, and in general occur between large firms and organisations that are leaders in their field. They are commonly used to establish standards, and may often be seen by regulators as anticompetitive, as they involve some degree of collusion.

Vertical collaborations occur among enterprises operating in related industries along the same value chain, where one partner produces inputs for the other. The latter may be a larger enterprise assembling or sub-assembling

products from parts and components acquired from different suppliers, including SMEs. It may also be a small systems integrator close to markets and obtaining equipment from larger suppliers. Vertical collaborations are less problematic, as the partners possess complementary but not competing capabilities and opportunities. Their primary (but not the only) motivation is towards reducing costs. Vertical alliances are especially important within global production networks and global value chains.

Defining strategic alliances

Strategic alliances are a particular subset of cooperative agreements, which have a significant *strategic* element to them. Strategic alliances are inter-firm cooperative agreements which are intended to affect the long-term product-market positioning of at least one partner.[40] In contrast to quasi-external, vertical solutions such as outsourcing and customer–supplier networks (which tend to involve lower levels of joint activity), strategic alliances are usually horizontal agreements (which tend to reflect a more complex strategic intent, and require closer collaboration).[41] The word 'strategic' suggests that such agreements are aimed at the longer-term objective of enhancing the value of the firm's assets.

There are a variety of cooperative agreements that do not have a primary strategic intent, but are primarily cost-economising: for instance, those associated with global value chains and production networks, where the primary objective is to reduce costs along a vertical chain. A strong strategic motive implies that the firm is often willing to forego (some degree of) cost savings in order to strengthen its portfolio of assets or its competitive position, or at least to defend its current position. Needless to say, most agreements have elements of both, but horizontal agreements tend to have a greater strategic aspect.

Alliances tend to create interdependence between the firms involved. The management interaction between the firms is coordinative and collaborative,

and the collaboration is flexible and dynamic. The nature of the relationship may evolve through time; and the agreement may be terminated after achievement of the strategic goal. They tend to be objective (and short term) focused, although the same firms may engage in serial agreements. Strategic alliances are a compromise between short-term, pure market transactions (e.g., spot transactions) and long-term, pure organisational solutions.[42]

Cooperative agreements act as complements rather than as substitutes for traditional entry modes. This is because the excessive use of non-internal resources entails considerable risks and costs. As a general rule, firms find it costly and difficult to access competencies from other firms.

Alliances are notoriously costly in terms of resources, and suffer from a high failure rate. Common reasons for their failure include: unfulfilled expectations, lack of trust, asymmetry of learning, incompatibility of organisational cultures, unfair or unclear division of control and responsibilities, as well as certain government policies and regulations. Indeed, most alliances have a 70 per cent failure rate, and even where successful, the majority of them last less than four years. A study[43] analysing terminated research alliances in the biotech industry found that only 15 per cent of the terminated alliances examined were successful, in the sense that they achieved their intended outcome (although an alliance may be a success from one partner's perspective and a failure from the other, because firms may learn asymmetrically). Given the strategic, uncertain and knowledge-based nature of the activities involved, these high rates of failure are not surprising.

Firms involved in alliances face a critical dilemma because they have to maintain the necessary knowledge exchange to achieve the alliance objectives, while at the same time avoiding the unintended leakage of valuable technology.[44] While this dilemma is common to most non-internalised modes of governance, it is more challenging in horizontal alliances. Although horizontal agreements provide opportunities for economies of scale and scope, there are also increased possibilities for the leakage of intellectual property

from one partner to the other. Obviously, these managerial challenges become greater if the agreements are of an international nature. The higher the differences in their national and organisational cultures, language or institutional environments, the higher the resources the partners need to invest in order to assure communication and control within the alliance. One of the main managerial challenges that firms face when doing alliances is associated with how to minimise the risk of opportunistic behaviour by the partner. Managers have to be careful with how much they invest in the relationship because, although these relationship-specific investments may improve communication and coordination among partners, they may also be a platform for undesired technology transfers and asymmetric learning among partners.[45]

Global value chains: combining multiple entry modes

As we discussed briefly in Chapter 1, in the twenty-first century the traditional view of an MNE as being fully integrated across its supply chain, and reliant primarily on full ownership to exert control is not as relevant. In order to compete more effectively in the highly competitive international markets, MNEs are supplementing or changing their old strategies towards less centralised organisational forms that rely on co-operative arrangements with the supply chain.

One of the major changes in the strategies and structures of MNEs has been the *externalisation* of parts of their supply chains; in their quest for operational efficiencies MNEs began to outsource parts of their supply chains to partner firms in foreign locations where the host CSAs provide better location advantages than the home CSAs (cheaper production factors, skilled labour, proximity to markets, etc.). This process has resulted in a new, differentiated organisational structure known as 'the global factory' (Buckley, 2009). Figure 2.13 presents an example of a **global value chain** of an MNE with globally distributed operations.

The global factory is divided into three parts (Buckley, 2009):

- **Core functions** are under full ownership and control of the MNE that controls the brand and undertakes design, engineering and R&D for the product.
- **Distributed manufacturing** is done by contract manufacturers – firms that perform manufacturing (and perhaps logistical) services for the MNE at low cost with mass production processes.
- **Local market adaptation** operations, such as warehousing, distribution and adaptation, are carried out by local firms with marketing skills and local market intelligence.

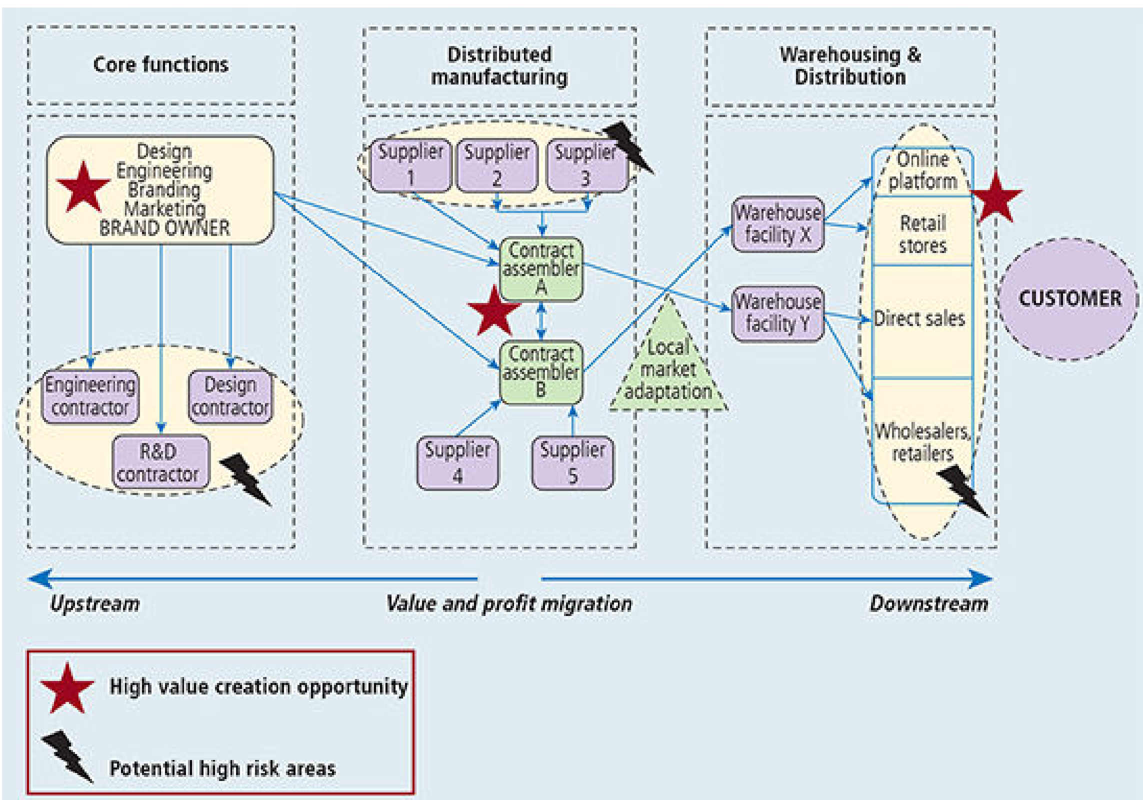

Figure 2.13 Globally distributed operations – global value chain

Source: Authors, adapted from Buckley, 2009.

The key advantage of the global factory is its *flexibility*, which enables the firm to re-allocate resources quickly and efficiently in response to increasing volatility arising from globalisation. A key purpose of flexible structures is to

provide *resilience*. Systems are resilient if they can absorb shocks. Resilient firms can thus survive downturns, crises and panics (like the ‘credit crunch’ of 2008).

Global factories are seen as an optimal structure to reconcile cost-reduction pressures with the need to be locally responsive (the integration–responsiveness framework discussed in Chapter 10). The global factory is, in essence, a network held together by control of key assets and flows of knowledge and intermediate products. A range of non-equity modes (licenses, franchises, R&D contracts, etc.) are used along the value chain to leverage core capabilities and resources and overcome gaps and bottlenecks. These global factories or networks are better known as strategic alliances and networks.

✔ Active learning check

Review your answer to Active Learning Case question 4 and make any changes you like. Then compare your answer to the one below.

4 What are the advantages of Starbucks using licensing and joint ventures when expanding abroad?

International joint ventures allow firms to combine resources, with Starbucks offering a globally recognisable brand, superior know-how in high-quality coffee, and economies of scale, but, as can be seen in 2007 when it failed to establish itself in India, joint ventures do have some weaknesses (e.g., lack of knowledge of the host country). In 2012, forming a joint venture with Tata Global Beverages allowed Starbucks to understand how to operate in the Indian market, while also leveraging off Tata's well-known brand identity in the Indian market.

International new ventures and 'born global' firms

An increasingly common term in the academic literature is the **'born global' firm**. Born global firms are also referred to as *international new ventures (INVs)* in the international entrepreneurship literature.[46] This is a term used to describe a firm that is immediately or very quickly reliant on a foreign presence to derive significant competitive advantage from the use of resources and the sale of outputs. Leveraging particular firm-specific advantages (FSAs), such as new technologies, unique products or services, or a valuable capability derived from one or more locations, such firms serve customers locally or globally. The very existence of born global firms can be due to their position as international entrepreneurial 'brokers,' exploiting commercial opportunities that arise from bridging resource inputs and market niches in different global locations.

International new ventures are subject to the multiple liabilities of smallness, newness and foreignness. They tend to show a stronger home-region orientation than large-sized and already-established MNEs. Given their limited resources, small firms can be expected to reduce risk by selecting nearby countries in their home region as the final destination of their internationalisation strategy from inception. As a result, international new ventures are likely to be born regionally, not globally, within their home region of the triad when going abroad into foreign markets.

The resource-based view (RBV) of firms proposes that, since international new ventures face a liability of foreignness by operating in unfamiliar and risky foreign markets, they should possess unique and distinctive resources and capabilities in order to overcome and counteract the liability effectively. The hard-to-replicate resources and capabilities internalised within firm boundaries are FSAs, and they can be best exploited in similar institutional contexts within intra-regions than across inter-regions, because they are usually location-bound. The resource-based view is discussed in greater detail in Chapter 3.

Transaction cost economics (TCE) also argues that international new ventures face a substantial level of transaction costs in both information search and monitoring processes when launching international operations across different foreign countries. We would normally expect transaction costs to be lower within the INV's home region of the triad due to spatial proximity, cultural and institutional similarities, psychical closeness, and, as a result, ease of transportation and communication. According to the organisational learning perspective, small and young ventures may be able to acquire hard-to-codify and tacit information about local customers' preferences and/or local business practices more easily within nearby countries in their home region than across different regions, because learning commonly takes place efficiently and effectively under culturally related and proximate external environments.

A number of commentators consider the growth of internet sales as an indication of the growing ease by which firms today can internationalise. While

it is relatively costless to be able to sell goods and services by listing products on eBay, Alibaba or Amazon, and become instantly international, such activities may distort the realities of their international business activities. A firm may be selling products or services abroad due to the marketing channel it is using (e.g., the internet); it does not mean it has operations abroad or that it tailors its marketing internationally.

THE INTERNATIONAL ACTIVITIES OF SMEs

How international are small firms? The data show that, in general, a relatively small number of SMEs sell products and services outside their domestic market, compared to the total number of active SMEs. When we consider another key measure of internationalisation, foreign direct investment (FDI), again SMEs are less prominent than large multinational firms as sources of FDI. This makes sense when it is considered that the majority of small firms in most countries are likely to be family-owned shops or hairdressers, restaurants and local tradesmen such as plumbers, painters or carpenters.

In the European Union, just a quarter of all SMEs export or have exported at some point during the past three years. Moreover, their international activities are mostly geared towards other countries inside the internal European market and only about 13 per cent of EU SMEs are active in markets outside the EU. However, SMEs are responsible for a larger proportion of total exports from some countries than we might expect.

Table 2.5 shows how international SMEs can be engaged in trade and/or FDI to access inputs or to sell outputs from abroad. If they stick to trading via imports (for inputs such as resources, materials or expertise) and exports (for their outputs, i.e., products or services) then they are relying solely on international market transactions to underpin their relative position in the industry value chain. As discussed earlier in this chapter, by engaging in FDI a firm ‘internalises’ a particular input or output activity based outside its home region. In this way it becomes a multinational firm.[47] So, for example, a small retailer might import products from abroad to sell locally, or export products to sell internationally. Only when this firm establishes its own shops abroad, to sell directly to customers, thereby internalising the overseas sales function, do

we refer to it as a multinational firm. Similarly, if it were to acquire a key supplier based abroad, thereby internalising the overseas supply function (and engaging in vertical integration along the value chain), we would refer to it as a multinational firm.

Table 2.5 Types of international SMEs by trade and FDI up and down the value chain

Different types of international SMEs	(1) International *inputs*: Foreign sourcing of materials or expertise . . .		(2) International *outputs*: Foreign sales of products or services . . .	
Internalisation; foreign ownership?	(1a) Yes. Input-oriented FDI	(1b) No. Sourcing via markets	(2a) Yes. Output-oriented FDI	(2b) No. Selling via markets
For example?	Foreign greenfield production facilities, procurement offices, R&D JVs	*Imports* from foreign suppliers, outsourcing contractors or online service providers	Part or fully-owned foreign distribution, retail outlets, aftersales service providers	*Exports* direct to foreign customers or via distributors, or online service delivery
Company examples:				
Intamarque	None	None	None	Exports to wholesalers and retailers
SMS Electronics	None	Small volume of materials imports	None	Exports direct to manufacturers
Forward Internet Group	None	Offshore software developers	None	Online commissions from eBay and internet sales firms globally
Wilton Group	Limited input of expertise from Brazil-based offices	None	Sales and technical services offices in Brazil	Exports to clients
Ultimate Products	Offices in Belgium and Hong Kong for sourcing new products	Imports wide range of products for UK clients	Offices in Belgium and Hong Kong for selling products	Exports wide range of products for foreign clients

The practical challenges for internationalising SMEs

In Chapter 1, we discussed the competitive strengths of large multinational firms, some of which stem from what Alfred Chandler, an emeritus professor at Harvard Business School, described as scale and scope advantages. Scale provides financial power and various economies of scale across the functions of the firm. This is combined with scope, which refers to the breadth and diversity of assets and capabilities that provide large firms with a portfolio of geographic and innovation-related options, enhancing their ability to attain superior profits.[48]

SMEs face significant limitations compared to large firms, across both these dimensions, making internationalisation strategies riskier. They do not have the financial muscle to 'buy' their way into new markets, or spend on customising products and brands for local customers. They also lack the range of specialists to draw on to shape and implement market-entry strategies, such as legal experts or managers with experience of local cultures. As described below, these limitations mean that small firms often need to be that much more entrepreneurial and innovative and/or take risky shortcuts, to expand across national borders. It also means that some elements of established theories of internationalisation fail to adequately explain the patterns and processes of small firm internationalisation.[49]

We already implied that the process of globalisation has acted as an accelerator of the rapid expansion of SMEs into the international business arena. ICT advancements enabled smaller firms to reach customers and resources well beyond their domestic markets. Yet SMEs are still less likely to internationalise than large firms, mostly due to lack of sufficient knowledge and resources to overcome the liability of foreignness. However, we note large disparities between SMEs' international strategies across different national contexts.

In the deployment of resources to tap into the new opportunities, more successful SMEs pay close attention to the mode of entry. There are two main practices in which SMEs pursue internationalisation: directly by entering foreign markets, or indirectly by staying in the domestic market. Each practice can be utilised via different entry modes as presented in Table 2.6 below.

SMEs are often assumed to opt for low equity and cooperative strategies because they have less access to financial assets or the level of human resources needed to support higher-commitment modes of entry. This also means that they have to quickly reach a level of profitability when they enter new markets because of their limited ability to raise investment capital. The specific challenges vary depending on the nature of the target country market

and the individual firm. One in-depth study of British SMEs in Japan[50] confirmed the general conclusion above: SMEs tended to enter into joint ventures and collaborative alliances with Japanese enterprises in order to gain local knowledge and credibility with *keiretsu* networks and to share the investment risks. However, a study of the British exporters[51] shows that exporting SMEs are more geographically diversified than generally assumed, with a significant number engaged in export activities beyond the European region.

Table 2.6 SMEs' internationalisation strategies

Direct entry modes to foreign markets	Indirect modes – staying in domestic markets
• Direct exports • Licensing/franchising • Strategic alliances/partnerships • FDI (greenfield wholly owned subsidiaries, M&As, joint ventures)	• Indirect exports (via domestic intermediaries) • Supplier to foreign firms • Acquiring licenses/franchise from foreign firms • Partners of foreign firms

INTERNATIONAL BUSINESS STRATEGY IN ACTION

Worrying times for Singapore's SMEs

Around 99 per cent of firms in Singapore are small and medium-sized enterprises (SMEs) and 85 per cent of these are, in fact, local enterprises with a small percentage being foreign owned. SMEs therefore play a crucial role in the development of the country's economy. Furthermore, Singaporean SMEs account for around 50 per cent of the nation's GDP and 70 per cent of all jobs in the domestic economy. These firms operate in a diversity of sectors such as manufacturing (19 per cent), wholesale and retail trade (18 per cent), business services (15 per cent), finance and insurance (13 per cent), other service industries (12 per cent) and construction (5 per cent). Around 70 per cent of nominal value added was generated by the service industries with a significantly small contribution to GDP coming from the goods producing industries. In 2018, sentiment among Singapore's small firms fell to a six-year low. There were significant concerns about the expected decline of Singapore's economy, especially in some sectors such as manufacturing, commerce and trading and business services. The lack of confidence in the economy was reflected in the SBF-DP SME Index, which fell from 54 per cent in 2015 to 50 per cent in 2018. Since 2009, the Singapore Business Federation (SBF), together with the DP Info Group, have conducted quarterly studies on business sentiments among Singapore SMEs. The objective of collecting this data is to provide a six-month outlook on the external activities and performance of Singapore SMEs. The index aims to help the SME community by providing an understanding of the likelihood that investment in SMEs will increase or decrease in the near future.

Table 2.7 illustrates changes in SBF-DP index within each quarter of 2018. Even though all sectors reveal a decreasing trend in business confidence, the most worrying sectors appear to be manufacturing (−2.1 negative percentage growth), commerce (−1.5 negative percentage growth) and trading and business services (−1.4 negative percentage growth). Aside from an overall decrease in business sentiment, turnover and profitability expectations are also expected to drop from 5.38 in the last quarter of 2018 to 5.22 in the first quarter of 2019 and from 5.29 to 5.19 respectively.

Table 2.7 Changes in SBF-DP SME Index in all four quarters of 2018

	1 1Q–2Q 2018	2 2Q–3Q 2018	3 3Q–4Q 2018	4 4Q18–1Q19	QoQ % change
Commerce and trading	51.4	52.0	51.2	50.5	−0.6
Construction and engineering	50.4	50.8	51.0	50.8	−1.2
Manufacturing	51.0	51.7	51.5	50.4	−0.2
Retail and food and beverage	50.6	51.3	52.0	51.3	−1.0
Business services	52.1	52.1	52.3	51.6	−0.8
Transport and storage	50.7	51.9	51.2	50.9	−1.0
Total	51.2	51.8	51.5	51.0	

Source: SBF-DP SME Index St. Graphics.

Trade tensions

To some extent, the data in the SBF-DP index reflected SME owner-managers' concerns about the global economic outlook including Singapore's exports with other parts of the world. The impact of trade tensions is likely to affect Singapore SMEs, particularly those which are most exposed to trading internationally. This is reflected in the fact that the percentage of commerce-wholesale SMEs which made their payments in time decreased from 45 per cent to 41 per cent quarter on quarter for the period ending September 2018. The increase in US–China trade tensions and potential introduction of new tariffs also began to lower profit expectations for Singaporean SMEs. Trade tariffs influence global SMNEs by reducing the competitiveness of their exports and by affecting their ability to sell in other markets. Even when the targeted host countries are not subject to trade tariffs, demand for intermediate goods from a country with trade tariffs such as China, is likely to increase the cost of doing business internationally. Because Singapore's largest trading partners, China and Malaysia were experiencing declining growth and challenging economic conditions, Singaporean SMEs began to reprioritise market opportunities and focus more on trading with emerging markets such as the-Philippines, India and Myanmar.

The role of the government

A number of initiatives to help SMEs were launched in this period by the local government. For instance, members of Parliament pointed out that in Singapore's rail system, most of the tunnelling projects were contracted to large foreign firms, whereas local construction companies had to rely on poorly paid subcontracted jobs. Because many SMEs were specialised, their size was found to limit their ability to compete with large foreign market players. Government initiatives revolved around

incentivising foreign firms to enter joint ventures with local construction companies and enable the SMEs to pick up expertise about new technologies and efficient processes. An increase in tax deductions for firms that undertook research and development (R&D) in Singapore was expected to also reduce some of the financial burden these firms carried; however, since many SMEs involved in R&D projects had little or no profits, these types of initiatives would not benefit them. Other initiatives to improve policy and reduce dependency on markets such as China included adherence to TPP (Trans-Pacific Partnership), a trade agreement signed between Singapore and 11 other countries aimed at changing trading conditions and lowering tariff and non-tariff barriers to increase trade and investment. TTP was expected to reduce the dependency that Singaporean firms had on China as their main trading partner. When the deal fell through as a result of the US Government's refusal to sign, these opportunities did not materialise.

In Singapore, SMEs deliver a lower percentage of GDP compared to foreign owned multinational firms, but hire a disproportionally large percentage of the country's workforce. Without these SMEs, the rate of unemployment could increase dramatically. For SMEs, which are often short of financial resources, loans become very important. The Singaporean Government is more focused on encouraging SMEs to understand the sources of financing available to them.

Sources: Ravi Philemon, 'Singapore SMEs starting to be affected by trade tensions', *The Independent*, 29 November 2018; 'Singapore SMEs could do with more to help them go global: accounting body', *The Business Times*, 12 July 2018; Annabeth Leow, 'Singapore SMEs among gloomiest in world: Poll', *The Straits Times*, 4 October 2017; 'Singapore SME profit outlook at its glummest since 2009', *Singapore Business Review*, 22 September 2016.

How do SME managers know which markets to enter?

Mathews and Zander[52] propose three milestones of international entrepreneurial processes: (1) the discovery of new opportunities; (2) the deployment of resources in the exploitation of these opportunities; and (3) engagement with competitors.[53]

The first major challenge for any firm looking to expand internationally is to decide which market location offers the best cost–benefit opportunity. Larger

firms can invest in the due-diligence process underlying this decision. Managers can employ in-house resources and expertise and/or external specialists to help identify the most promising country markets in which to expand. As described in Chapter 15, this can entail a complex analysis comparing the relative risks and rewards of different country markets.

Decision-makers in both small and large firms also rely on their personal experience and existing international network relationships, both informal and formal, to assess the potential of different markets. This includes knowledge gained from existing buyers and suppliers and alliance partners, even when these are import and export contractors.[54] But there is evidence that these personal experiences and relationships are much more important to the decision-making process in small firms. Studies show how small firms, and particularly the smallest, owner-managed enterprises, tend to decide which markets to enter on the basis of fairly subjective evidence. This includes the views and opinions of personal contacts abroad and the experience and personal characteristics of small firm owners themselves.[55] A senior manager might spot a market opportunity during a family holiday abroad and this chance experience can be a strong influence on a small firm's market expansion strategy.

A study by Collinson and Houlden[56] used **mental maps** to capture the perceptions of decision-makers in a sample of British SMEs of the relative risks and rewards of foreign markets. Mental maps are defined as 'cognitive representations of the nature and attributes of the spatial environment'. They represent images of spatial environments developed by individuals based on their collated influences and experiences, and information available to them. Figure 2.14 shows the mental map for all of the firms in the study, with darker shading and higher numbers denoting more attractive foreign markets.

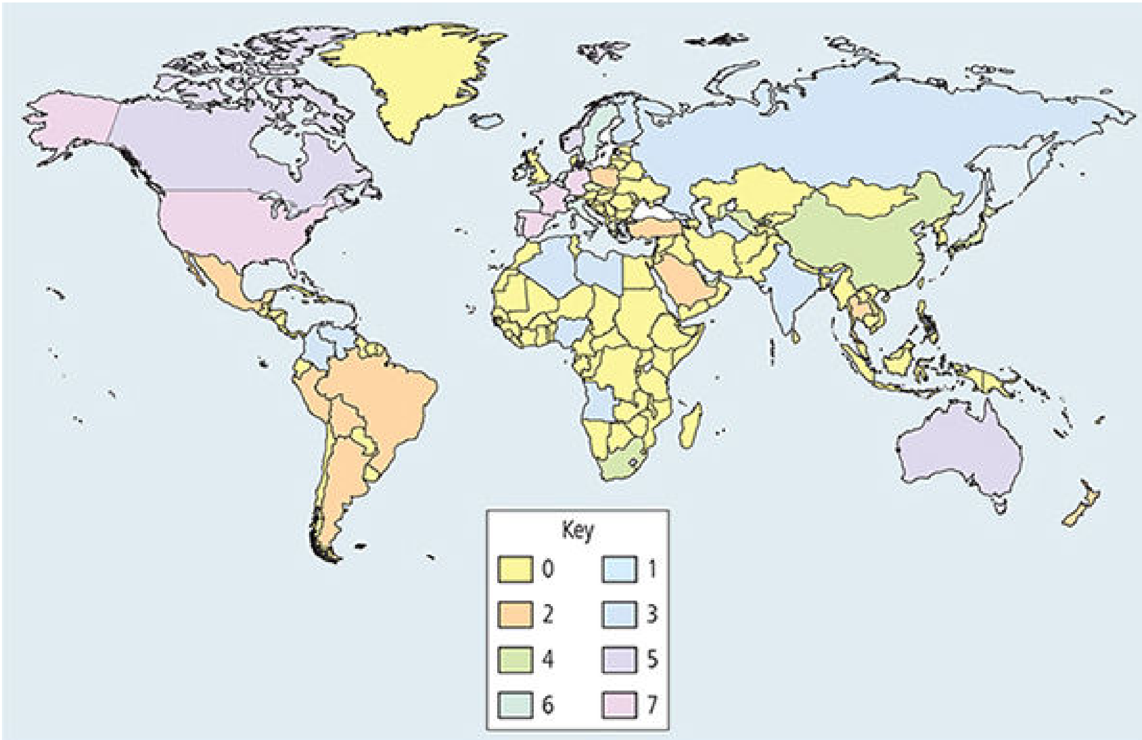

Figure 2.14 **Risk vs. reward: country market attractiveness for SME managers**

Source: S. Collinson and J. Houlden, 'Decision-making and market orientation in the internationalization process of small and medium-sized enterprises.' Warwick Business School Working Paper (2005).

The map shows that mainland Europe and the United States represent the most attractive markets, given their size and familiarity to these British respondents. Much of Africa and parts of the Middle East, Southeast Asia and central Europe are either less well known or seen to be high-risk areas. Collinson and Houlden concluded that the mental maps of decision-makers reflect their individual and group perceptions of opportunity and risk and subsequent geographical bias. They vividly illustrate how 'psychic distance' – the perceived degree of cultural, social and psychological differences between a home country and a foreign country – operates in practice. These perceptions form the basis of internationalisation decisions.

The study also compared the views of managers in small firms that had internationalised, and therefore had experience of international location selection and market-entry, with non-internationalised firms. Figure 2.15

compares their responses. It shows how factors such as language, future potential growth, currency stability and foreign investment restrictions are rated higher as influences on the country selection decision for firms that have experience of internationalisation. Managers in non-international firms are more concerned about the international financial standing of the target market, general ease of access and climate. The relative ratings of language and climate show a complete contrast. Managers who have direct experience of working across language barriers know how this creates far more additional complexity, uncertainty and risk than differences in the weather!

Modes of entry and adaptation for success in foreign markets

There is a general consensus across the entrepreneurship literature that more innovative small firms engage in exporting because they are producing superior products relative to local competitors. Similarly, small firms that expand internationally through FDI are likely to be more innovative than their counterparts because they have successfully adapted not just products and services but their management practices to other cultural and institutional contexts. In this way, innovation and internationalisation are complementary activities.[57]

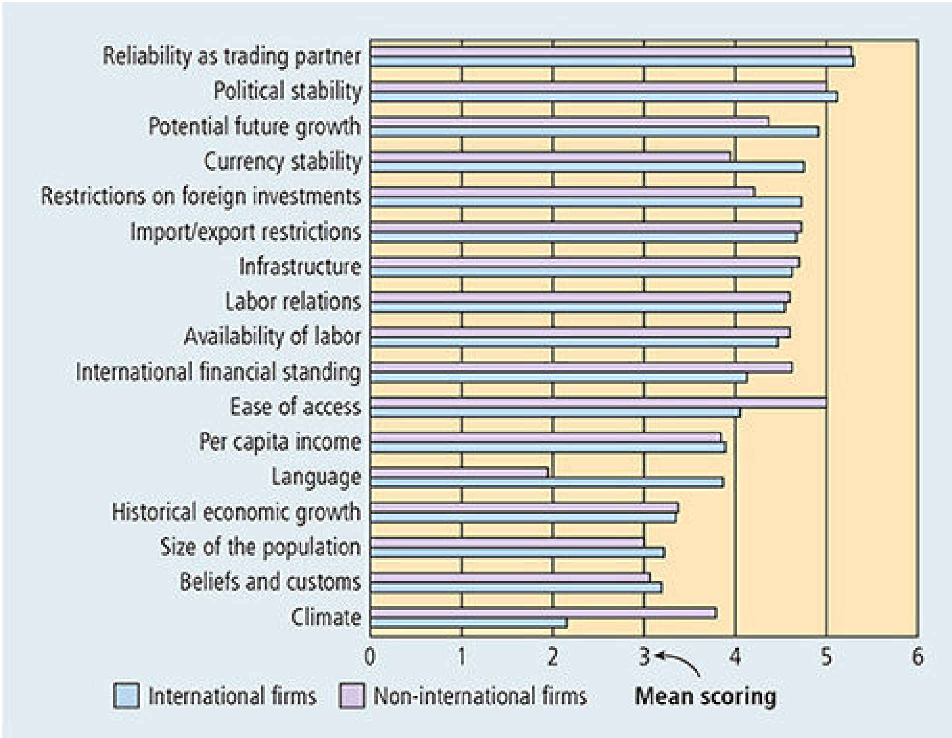

Figure 2.15 Foreign market selection criteria for international and non-international SMEs

Source: S. Collinson and J. Houlden, 'Decision-making and market orientation in the internationalization process of small and medium-sized enterprises.' Warwick Business School Working Paper (2005).

In terms of modes of market entry, studies suggest that firms tend to opt for higher-commitment and higher-risk entry modes (such as M&A or greenfield investments) with increasing firm size. SMEs are often assumed to opt for low equity and cooperative strategies because they have less access to financial assets or the level of human resources needed to support these higher-commitment modes of entry. This also means that they have to quickly reach a level of profitability when they enter new markets because of their limited ability to raise investment capital.[58]

Clearly the specific challenges vary depending on the nature of the target country market and the individual firm. One in-depth study of British SMEs in Japan confirmed the general conclusion above, showing that small firms tended to enter into joint ventures and collaborative alliances with Japanese enterprises in order to gain local knowledge and credibility with *keiretsu* networks and to

share the investment risks. The study also showed how market barriers faced by all firms proved to be more challenging for small firms. These included:

- The high costs of start-up and operation, including costs of living and working in Japan, the high tax burden, and labour and property costs.
- Local recruitment difficulties, partly stemming from traditional lifetime employment and lack of status for the Japanese working in small foreign enterprises.
- Complex employment legislation and very different HRM practices, including the culturally embedded obligations of employers in Japan adding to the more generic barriers of language and culture.
- Market restrictions, including barriers associated with trading associations, '*dango*' and *keiretsu* structures, sometimes supported by government standards and trading legislation. The 'tied' system of distribution in Japan, bound by strong face-to-face ties as well as cross-shareholding or financing arrangements between sellers and buyers at each level, proved to be a particular problem. These add to the costs and difficulties of getting products introduced into the market and distributed across different regional markets.
- Government-related complications such as local and national standards – accounting and taxation regulations are not 'user-friendly' for non-Japanese and governance processes can be ambiguous.
- Demanding customers and intense rivalry, which have been the drivers of Japanese innovative capabilities in the past. These place huge pressures on foreign entrants to adapt marketing, product and service quality and features, and aftersales support to meet the expectations of consumers and corporate customers.[59]

Small survivors are the SME success stories in large, complex markets like Japan. Their success is evidence of their dynamic capability to adapt and their ability to continually innovate. Lessons for other firms are relevant because

these SMEs have proved their ability to adapt products and services as well as their own processes and management practices to the economic, institutional and cultural contexts of foreign markets. Moreover, they have adapted not only to fit into these competitive environments but to succeed against local competitors. Their ‘fitness’ is of a Darwinian kind.

KEY POINTS

1. For an MNE to be able to compete against domestic firms in the host county, they need ownership advantages or FSAs. There are three types of ownership advantages, asset-type FSAs, transaction-type FSAs and recombinant FSAs
2. Location advantages are an important determinant of where and how MNEs engage in international activities. There are a variety of motivations for, and modes of, internationalisation, including market-seeking FDI, asset-augmentation and efficiency-seeking FDI.
3. Modes of entry can be partially explained through internalisation theory. These include non-equity modes (such as exports, licensing and franchising) and equity modes (M&A, joint venture and greenfield). An MNE has to decide whether to internalise its assets and engage in FDI.
4. The FSA–CSA matrix is a good tool to determine what strategies MNEs should adopt and helps explain how different firms operate in different markets. Some firms rely more on internalising CSAs, for example state-owned oil companies; others are more reliant on the FSAs.
5. The accumulation of knowledge through some international activities, such as exports, may lead to a growing commitment to foreign markets (e.g., through FDI). This process is known as the Uppsala model. Firms are more likely to expand into countries which are psychically close to them, and once they acquire more experience in doing business abroad will expand to more psychically distant countries. 'Born global' firms are different in that they internationalise near the beginning or at the point of their founding.

6 Due to technological advancements in communication infrastructure and decreased transportation costs, there has been a recent rise in so-called ‘born global’ firms that early on, if not from inception, seek to derive competitive advantage from having foreign assets and operations.

7 Because they lack resources and the scale and scope advantages of large MNEs, small and medium-sized enterprises (SMEs) that have managed to successfully internationalise often demonstrate some of the most effective dynamic and innovative capabilities.

Key terms

- **Meta-integrator**
- **global value chains**
- **‘born global’ firms**
- **mental maps**

REAL CASE

Walmart Inc.

Walmart Inc. – the world's biggest food retailer – opened its first international store in Mexico City in 1991 and then it expanded to parts of Canada, Latin America, Germany, United Kingdom, China and South Korea. In 1993, only around 1 per cent of Walmart stores were located outside the United States. By 1998, the number of stores operated internationally grew to 18 per cent of total number of stores. Between 1995 and 1998, over 5 per cent of the company's sales revenues came from its international operations. The international business model applied to new markets was the same as that used by the company in the United States: (1) Walmart stores which offered clothing, small appliances, hardware, sporting goods and similar items; (2) Sam's clubs, which offered bulk products to customers who had opted for warehouse memberships; and (3) Walmart hypermarkets, which combined the inventories of discount stores with full-line supermarkets. In 2018, Walmart was expanding its online grocery pickup service in countries such as Canada, Mexico and China.

By 2018, still under 24 per cent of sales came from Walmart's international retail stores spread across 27 countries. These included sales from the company's 2,358 stores in Mexico, 642 stores in the United Kingdom, 443 stores in China, 336 stores in Japan and 20 stores in India. Entering new markets, however, has not always been easy for the company. Growth and expansion of their business model in some international markets was becoming increasingly complex. As the case illustrates, cultural and regulatory differences between home and host markets can make establishing a dominant foreign market presence, more challenging. This is particularly the case when large, established multinational companies such as Walmart, seek to export the business model which has been successful in their home markets into new host country contexts.

Walmart in Germany

Many foreign firms targeting the mainland European market seek to enter Germany. Germany has a strong economy, a high per-capita GDP and a population with high levels of disposable income. But Germany is also home to the largest supermarket discounters. Supermarket chains such as Aldi and Lidl dominate the grocery business. German consumers, despite their high buying power, are known to be among the most price-conscious in Europe and highly reluctant to spend a significant amount of

time in hypermarkets. The margins in the food retail sector in Germany range between 0.5 per cent and 1 per cent compared to 5 per cent in the United Kingdom. When Walmart entered Germany in 1997, the company first acquired 21 stores from the supermarket chain ‘Wertkauf’ and then 74 stores from the supermarket chain ‘Interspar’. As the fourth largest operator of supermarkets in Germany, the company planned to further expand to 500 stores.

After entering the German market, the company soon learned that if you choose to follow a low-cost strategy and provide a wide range of items, you need to expand rapidly before your competitors do. Yet, Walmart’s ‘Wertkauf’ stores were small and hosted only a limited range of items. This was paralleled by the growth of competitors such as ‘Metro’ which undercut Walmart, with the latter having to revoke products because it was too difficult to compete on cost. While the strategy of ‘Everyday low prices’ proved to be very successful for Walmart in the United States, it was somewhat taken for granted in Germany where customers were used to being offered low prices.

The managers of Walmart were also not familiar with laws and regulations in Germany and even broke them at times. Unlike the United States, Germany had some of the strongest trade unions in the world such as Ver.di (over 2 million members), which had significant influence over how businesses operations were regulated. Ver.di sued Walmart in 2000 for not publishing their profit and loss statements in due time for which the company was sentenced to pay a fine. Walmart also tried to drive competitors out of business through price wars. The company developed a new brand (‘Smart Brand’) and sold the items below manufacturing cost. This drove competitors to also lower their prices and reduced industry profitability as a whole. The Federal Cartel office stopped the price war, which was a competitive practice not highly disregarded in Germany.

The managing directors of Walmart refused to allow these setbacks to thwart their efforts. They continued to push their US business model to German consumers. However, when new products are introduced, cultural factors also matter. To compete more effectively, Walmart decided to invest in customer service, as discount retailers were notorious for not providing very good service. The new programme titled the ‘ten foot rule’ meant that every ten feet there would be a Walmart employee waiting to offer help to customers. The customer reaction was negative, as German customers were not used to talking to employees but rather to use the self-service option. The same cultural factors became a problem when Walmart decided to manage the German locations from the United Kingdom, meaning the corporate language became English. The older German managers who did not speak

English felt left out and eventually decided to leave the company. As these key business connections were lost, suppliers such as Adidas and Nike refused to work with the company, leading to a loss in Walmart's range of goods. Walmart never managed to expand beyond 95 stores and sold its operations to 'Metro', one of Germany's largest retail groups. Walmart exited the German market in 2006 with a loss of one billion dollars before tax.

Walmart in China

China is the world's second largest economy and biggest grocery market, with Chinese grocery sales anticipated to grow from $1,119 billion in 2015 to $1.491 billion in 2020. Western supermarket chains such as Tesco (UK) have historically struggled to gain presence in the Chinese market. Walmart China began in 1996 when the company opened a hypermarket in Shenzhen through a joint venture agreement with Hong Kong listed company, Citic Pacific. When Walmart decided to enter this market in the late 1990s, despite having found a partner with some local knowledge and political ties, it still had some major hurdles to overcome. Walmart's challenges in China reflect the company's misunderstanding of the country's economic, political and cultural environments. China's grocery market remained highly fragmented and locally focused. Given the size of the country, Chinese consumers preferred shopping in small, local stores where it was more convenient to travel to. Consumers were also patient in their purchases as they compared items based on their quality, brands and prices. The younger generation of Chinese consumers, preferred to buy grocery online rather than offline. Over 90 per cent of consumers preferred to use mobile payment systems such as AliPay and WeChat than cash or credit cards. As a result, there were many specialised grocery retailers in China, focusing on narrow range of products such as organic products, or meat products. Nearly all local supermarket chains were domestic and smaller in size. The larger local retailers such as Yonghui, Lianhua or China Resources Vanguard sold their products through a complex distribution system that typically involved between three and five layers of intermediaries. Since 2016, companies such as Alibaba Group Holding Ltd and Tencent Holdings Ltd have started to cut deals to integrate traditional shopping with online shopping.

Walmart's business model also clashed with traditional business structures. Its low-cost format put more attention on finding locations that can accommodate the hypermarkets, lowering product prices and achieving supply chain efficiency. Yet, scaling up the business became a challenge because

achieving supply chain efficiency was difficult in a country like China which lacked a sophisticated technological and physical infrastructure to transport goods from one region to another. China therefore not only presented great opportunities but also involved a high risk of failure, particularly if the company did not adapt its business model. To overcome the problems associated with Chinese consumption habits and infrastructure limitations, Walmart looked to enlist new partners. In 2016, Walmart formed a strategic alliance with Chinese company JD.com to provide consumers with online retailing services. JD.com is the largest e-commerce company in China by revenue and it was believed that their online capabilities and understanding of the Chinese consumer would increase Walmart's chances of success in China. In April 2018, Walmart announced the opening of its first small format high-tech grocery store in China, where consumers could use their smartphones to pay for items that were available on JD Daojia, an affiliate of JD.com. The store would be one tenth of the size of a traditional Walmart hypermarket and would be located in a residential area. Customers could check out and pay using Tencent's WeChat pay system without having to go through a cashier. Their partner, JD.com would also be able to deliver items within a 1.2-mile radius in under 30 minutes. Walmart has been able to maintain its foothold in the Chinese market. Although Walmart's $7.5 billion in sales represents only 2 per cent of their total revenues, sales in China have grown in the last decade, while sales in the United States have decreased.

Sources: Michael Sasso, Sarah Ponczek and Sam Chambers, 'Walmart sheds grow-everywhere plan in refining global strategy', *Bloomberg*, 30 April 2018; Mark Landler, 'Wal-Mart gives up Germany', *New York Times*, 28 July 2006; Warren Shoulberg, 'Lost in translation: Why Walmart and so many other U.S. retailers fail overseas', *Forbes*, 4 May 2018; Bryan Pearson, 'German Lessons: What Walmart could have learned from Lidl, and vice versa', *Forbes*, 5 February 2018; Andrew Clark, 'Wal-Mart pulls out of Germany', *The Guardian*, 28 July 2006; Harrison Jacobs, 'Photos reveal what it's like to shop at Walmart in China – which is shockingly different from the U.S. and struggling to compete', *Business Insider*, 1 May 2018; Orville Schell, 'How Walmart is changing China', *The Atlantic*, December 2011; Robert Salomon, 'Why Walmart stumbled on the road to China', *Fortune*, 21 February 2016.

1 What are the firm-specific advantages of Walmart?

2 What specific cultural and political barriers to entry does it face?

3 Why was Walmart more successful in China than in Germany?

REAL CASE

Back again? IKEA's re-entry into Japan

The origins of Swedish furniture giant, IKEA, can be traced back to its founder. Ingvar Kamprad was an entrepreneur who began selling pens, wallets and watches door-to-door in 1943. Entering the furniture market at the time was very difficult to an entrepreneur and as Ingvar tried to sell his low-priced furniture, rivals began to increase barriers to entry by banning local suppliers from providing raw materials to IKEA. The company was also not allowed to attend industry exhibitions to showcase its furniture. What could the company do to develop an advantage in the market? IKEA began to import raw materials from Poland and design their own furniture, which was showcased to customers at exhibitions organised by IKEA employees. At present, IKEA is the largest furniture retail chain in the world, with over 400 stores in 41 countries and territories and over 800 million customers per year. Most of these stores are fully or partially owned by the IKEA Group, with the remaining few being owned and run by the company's franchise partners.

Over the decades, the retailer has built a strong international presence. The international expansion of IKEA began in Norway in 1963 followed by Denmark in 1969 where the company set up small stores. The first IKEA store outside of the Scandinavian region was established in Switzerland in 1973, followed by stores being opened in Germany (late 1973), the Netherlands (1983) and Luxembourg (1991), among others. IKEA's strategy was to provide customers with low priced, but fashionable furniture, which everyone could afford and which they could take and assemble at home. This business model was implemented in every international market entered.

IKEA's initial entry into Japan

Although IKEA has been successful in establishing a strong presence in most foreign markets entered, IKEA's history in Japan reflects the challenges of replicating their home market strategy into international markets. Japan was one of the first Asian markets which IKEA considered as part of their international expansion strategy. After World War II, the Japanese economy grew exponentially, and the country changed from a developing to a developed nation. In 1968, with an annual growth in per-capita GDP of 10 per cent, Japan had become the world's second largest economy. The number of Japanese people living in the cities also grew exponentially, meaning more potential customers for

IKEA's products. The company entered the Japanese market for the first time in 1974 via a joint venture arrangement with a local partner. The joint venture was chosen as a mode of entry in order to offset potential financial risks in the market. Yet, the company soon realised that the Japanese market was very different in terms of its culture, lifestyle and shopping behaviour compared to the other European markets in which the company was already operating.

IKEA's exit and re-entry

Following a period of poor sales, the company exited the Japanese market in 1986, 12 years after their initial foray into Japan. IKEA's market failure was attributed to the fact that the company did not have a good understanding of how to communicate their business model to the Japanese customer. Japanese customers were also not ready for the 'do-it-yourself' furniture style. The Japanese culture was influenced by the historical lack of resources of the country, which translated into customers not necessarily wanting furniture that was seen as fashionable but not durable, and which would have to be replaced every few years. Further, even when Japanese customers were willing to buy furniture from IKEA, they realised that the products sold were too large for the size of their homes. Japanese homes were, on average, smaller than Swedish homes. IKEA's local joint venture partner at the time was unable to help the company understand how to adapt its strategy to local demand and attract customers. The joint venture partnership was therefore dissolved and IKEA left the Japanese market. Starting with the early 2000s, news about IKEA's return to Japan with a new market strategy and fresh product line began to emerge.

In April 2006, IKEA decided to finally re-enter Japan, which remained the second largest economy and retail market in the world. The investment – a 43,000-sq.-meter site wholly owned by the company with plans to open 14 more stores until 2020 – showed IKEA's high commitment to the Japanese market. After a 20-year hiatus, the company had learned from its past mistakes and decided that size of the furniture was key when selling to a market such as Japan. This decision came from the market research conducted by the company, in the period of time they spent out of the market. IKEA staff visited a large number of Japanese houses to understand how these people cook, how they spend their leisure time, the environment in which they sleep and take a bath. This time around, IKEA opted to retain full control of its operations in the Japanese market.

Yet, for a retailer like IKEA, a key source of competitive advantages lies in their ability to achieve standardisation by providing the same built products across different international markets and achieve efficiency by flat packing their furniture for easy transport. Therefore, adapting its products to international markets would have increased costs significantly for the company. In turn, the company decided to select 7,500 items out of its 10,000-product line-up that were more suited to the sizes and preferences of Japanese customers. In the time they spent out of the market after exit, the company had also accumulated more experience with tailoring its range of products to the needs of local consumers. Having sold furniture in locations such as New York, Paris and London, they realised that they could apply this know-how to better provide for areas with small spaces. Further, IKEA introduced 'Tebura de box' which was a service that enabled customers to post all their desired products in a box, which would then be delivered to their homes. This was designed to address the problem faced by Japanese customers who came to the store via public transport. Given its success, this service was later implemented in other international markets.

The Japanese market remains tough as the company continues to experience problems such as: restrictions on the acquisition of land to build new superstores, regulations around local adaptation of product labelling and restrictions on the type of food products that can be imported into Japan and served in IKEA restaurants. The deregulation of Japanese Large Scale Retail Store Law, which affected the company's ability to set up operations in Japan, was a step forward.

Sources: Valerie Chu, Alka Girdhar and Rajal Sood, 'Couching tiger tames the dragon', *Business Today*, 21 July 2013; 'Milestones in our history', *Inter IKEA Group*, 2018; Yumi Wijers-Hasegawa, 'Sweden's IKEA back in Japan after 20-year hiatus', *Japan Times*, 26 April 2006; 'Investing in Japan – IKEA Japan KK', *Japan External Trade Organization*, January 2015; Lisa Twaronite and Ariana Nobles, 'IKEA set to try again in Japan', MarketWatch, 22 July 2014; Victoria Vlisides, 'IKEA Japan putting it all together for the future', *Japan Today*, 19 March 2018.

1 Why did IKEA decide to venture into Japan?

2 Why did the company fail to perform well in Japan? What lessons can retailers draw from this?

3 What FSAs did the company require to compete effectively in Japan?

4 What were the advantages of IKEA switching from a joint venture to a wholly owned subsidiary when re-entering the Japanese market?

NOTES

1 A. M. Rugman, *Inside the Multinationals: The Economics of Internal Markets* (New York: Columbia University Press, 1981); Alan M. Rugman (ed.), *International Business in Canada: Strategies for Management* (Toronto: Prentice Hall Canada, 1989), chapters 8, 13; Alan M. Rugman, *The Theory of Multinational Enterprises* (Cheltenham: Edward Elgar, 1996); S. C. Collinson and R. Narula, 'Asset recombination in international partnerships as a source of improved innovation capabilities in China', *Multinational Business Review*, vol. 22, no. 4 (2014), pp. 394–417.

2 J. H. Dunning, 'The eclectic (OLI) paradigm of international production: past, present and future', *International Journal of Economics and Business*, vol. 8, no. 2 (2001), pp. 173–90.

3 A. M. Rugman, 'Reconciling internalization theory and the eclectic paradigm', *Multinational Business Review*, vol. 18, no. 2 (2010), pp. 1–12.

4 R. Narula, 'Do we need different frameworks to explain infant MNEs from developing countries?' *Global Strategy Journal*, vol. 2, no. 3 (2012), pp. 188–204.

5 R. Narula and G. D. Santangelo, 'Location and collocation advantages in international innovation', *Multinational Business Review*, vol. 20, no. 1 (2012), pp. 6–25.

6 R. Narula, 'Keeping the eclectic paradigm simple', *Multinational Business Review*, vol. 18, no. 2 (2010), pp. 35–50.

7 J. Cantwell and R. Narula, 'The eclectic paradigm in the global economy', *International Journal of Economics of Business*, vol. 8 (2001), pp. 155–72.

8 A. M. Rugman and A. Verbeke, ‘Subsidiary-specific advantages in multinational enterprises’, *Strategic Management Journal*, vol. 22, no. 3 (2001), pp. 237–50.

9 G. D. Santangelo and K. E. Meyer, ‘Extending the internationalization process model: increases and decreases of MNE commitment in emerging economies’, *Journal of International Business Studies*, vol. 42, no. 7 (2011), pp. 894–909.

10 A. Verbeke and N. S. Greidanus, ‘The end of the opportunism vs. trust debate: bounded reliability as a new envelope concept in research on MNE governance’, *Journal of International Business Studies*, vol. 40 (2009), pp. 1471–95; J.-F. Hennart, ‘Emerging market multinationals and the theory of the multinational enterprise’, *Global Strategy Journal*, vol. 2, no. 3 (2102), pp. 168–87.

11 R. Narula, *Multinational Investment and Economic Structure* (London and New York: Routledge, 1996); R. Narula, ‘Keeping the eclectic paradigm simple’, *Multinational Business Review*, vol. 18, no. 2 (2010), pp. 35–50.

12 R. Narula and G. D. Santangelo, ‘Location and collocation advantages in international innovation’, *Multinational Business Review*, vol. 20, no. 1 (2012), pp. 6–25.

13 U. Andersson, I. Bjorkman and M. Forsgren, ‘Managing subsidiary knowledge creation: the effect of control mechanisms on subsidiary local embeddedness’, *International Business Review*, vol. 522, no. 14 (2005), pp. 521–38.

14 P. J. Buckley and M. C. Casson, ‘The internalisation theory of the multinational enterprise: a review of the progress of a research agenda after 30 years’, *Journal of International Business Studies*, vol. 40, no. 9 (2009), pp. 1563–80.

15 A. Rugman, A. Verbeke and Q. T. K. Nguyen, ‘Fifty years of international business theory and beyond’, *Management International Review*, vol. 51, no. 6 (2011), pp. 755–86.

16 J. Wolf and W. G. Egelhoff, ‘A reexamination and extension of international strategy–structure theory’, *Strategic Management Journal*, 23 (2002), pp. 181–9.
17 Unilever, *Annual Report*, 2003.
18 See Michael E. Porter, *The Competitive Advantage of Nations* (New York: Free Press/Macmillan, 1990).
19 See Michael E. Porter, *Techniques for Analyzing Industries and Competitors* (New York and London: Free Press, 1980).
20 A. M. Rugman, C. Oh and D. Lim, ‘The regional and global competitiveness of multinational firms’, *Journal of the Academy of Marketing Science*, vol. 40, no. 2 (2012), pp. 218–35.
21 G. Benito, ‘Why and how motives (still) matter’, *Multinational Business Review*, vol. 23, no. 1 (2015), pp. 15–24.
22 A. Cuervo-Cazurra and R. Narula, ‘A set of motives to unite them all? Revisiting the principles and typology of internationalization motives’, *Multinational Business Review*, vol. 23, no. 1 (2015), pp. 2–14.
23 A. Cuervo-Cazurra, R. Narula and C. A. Un, ‘Internationalization motives: sell more, buy better, upgrade and escape’, *Multinational Business Review*, vol. 23, no. 1 (2015), pp. 25–35.
24 A. Cuervo-Cazurra and R. Narula, ‘A set of motives to unite them all? Revisiting the principles and typology of internationalization motives’, *Multinational Business Review*, vol. 23, no. 1 (2015), pp. 2–14.
25 E. Beleska-Spasova, ‘The role of firm-specific advantages in UK export initiation’, *Multinational Business Review*, vol. 19, no. 2 (2011), pp. 168–94.
26 S. Athreye, A. Tuncay-Celikel and V. Ujjual, ‘Internationalisation of R&D into emerging markets: Fiat’s R&D in Brazil, Turkey and India’, *Long Range Plan*, vol. 47 (2014), pp. 100–14.
27 P. Criscuolo, R. Narula and B. Verspagen, ‘Role of home and host country innovation systems in R&D internationalisation: a patent citation

analysis', *Economics of Innovation and New Technology*, vol. 14 (2005), pp. 417–33.

28 S. Zaheer, 'Overcoming the liability of foreignness', *Academy of Management Journal*, vol. 38 (1995), p. 341.

29 J. Johanson and J. E. Vahlne, 'The internationalization process of the firm, a model of knowledge development and increasing foreign market commitment', *Journal of International Business Studies*, vol. 8, no. 1 (1997), pp. 22–32; J. Johanson and F. Wiedersheim-Paul, 'The internationalization of the firm: four Swedish cases', *Journal of Management Studies*, vol. 12, no. 3 (1975), pp. 305–22.

30 K. Eriksson, A. Majkgard and D. D. Sharma, 'Path dependence and knowledge development in the internationalization process', *Management International Review*, vol. 40, no. 4 (2000), pp. 307–28.

31 P. Brewer, 'Psychic distance and Australian export market selection', *Australian Journal of Management*, vol. 32, no. 1 (2007), pp. 73–92.

32 Shawna O'Grady and Henry W. Lane, 'The psychic distance paradox', *Journal of International Business Studies*, vol. 27, no. 2 (1996), pp. 309–33.

33 J. H. Dunning and S. M. Lundan, *Multinational Enterprises and the Global Economy* (Cheltenham: Edward Elgar, 2008).

34 Y. Pan and D. Tse, 'The hierarchical model of market entry modes', *Journal of International Business Studies*, vol. 31, no. 4 (2000), pp. 535–54.

35 J.-F. Hennart, 'Down with MNE-centric theories! Market entry and expansion as the bundling of MNE and local assets', *Journal of International Business Studies*, 40 (2009), pp. 1432–52.

36 J.-F. Hennart, D. J. Kim and M. Zeng, M., 'The impact of joint venture status on the longevity of Japanese stakes in US manufacturing affiliates', *Organization Science*, vol. 9, no. 3 (1996), pp. 1–14.

37 P. Deng, 'Why do Chinese firms tend to acquire strategic assets in international expansion?' *Journal of World Business*, vol. 44, no. 1 (2009), pp. 74–84.

38 R. Narula and G. Duysters, 'Globalisation and trends in international R&D alliances', *Journal of International Management*, vol. 10, no. 2 (2004), pp. 199–218.

39 P. Dicken, *Global Shift: Mapping the Changing Contours of the World Economy*, 6th ed. (New York: Guilford Press, 2011).

40 J. Hagedoorn, 'Understanding the rationale of strategic technology partnering: inter-organizational modes of cooperation and sectoral differences', *Strategic Management Journal*, vol. 14 (1993), pp. 371–85.

41 R. Narula and J. Hagedoorn, 'Innovating through strategic alliances: moving towards international partnerships and contractual agreements', *Technovation*, vol. 19 (1999), pp. 283–94; R. Narula, 'Strategic partnering by EU firms: a rejoinder', *Journal of Common Market Studies*, vol. 39 (2001), pp. 159–64.

42 R. Narula and A. Martinez-Noya, 'International R&D alliances by firms: origins and development', in Daniele Archibugi and Andrea Filippetti (eds.), *The Handbook of Global Science, Technology, and Innovation* (Hoboken, NJ: Wiley-Blackwell, 2015), pp. 148–74.

43 J. Reuer and M. Zollo, 'Termination outcomes of research alliances', *Research Policy*, vol. 34 (2005), pp. 101–15.

44 S. Mudambi and S. Tallman, 'Make, buy or ally? Theoretical perspectives on knowledge process outsourcing through alliances', *Journal of Management Studies*, 47 (2010), pp. 1434–56.

45 A. Martinez-Noya, E. Garcia-Canal and M. F. Guillen, 'R&D outsourcing and the effectiveness of intangible relationship-specific investments: may proprietary knowledge be walking out the door?' *Journal of Management Studies*, vol. 50, no. 1 (2013), pp. 67–91.

46 B. M. Oviatt and P. P. McDougall, ‘Defining international entrepreneurship and modeling the speed of internationalization’, *Entrepreneurship Theory and Practice*, vol. 29, no. 5 (2005), pp. 537–53.

47 This distinction lies at the heart of Oliver Williamson’s ‘transaction cost economics’ (TCE) between market and hierarchy. The latter refers to the situation where transactions are internalised within the firm (‘hierarchy’) because this incurs lower transactions costs compared to the market. In a similar vein, but with a different approach, in 1959 Edith Penrose asked ‘why do firms do what they do?’ i.e. what determines the boundaries of the firm? She explored why firms left some business activities to the market and encompassed others internally. This is of central interest in international business theory, but only when the internalisation involves incorporating overseas assets or business activities into the firm, rather than relying on (import–export) markets. By taking this step, firms become multinationals. E. Penrose, ‘Profit sharing between producing countries and oil companies in the Middle East’, *Economic Journal*, vol. 69, no. 274 (1959), pp. 238–54.

48 A. D. Chandler, *Strategy and Structure: Chapters in the History of the Industrial Enterprise* (Cambridge, MA: MIT Press, 1990).

49 For a summary, which particularly focuses on the reliance of small firms on intangible capabilities for successful internationalization, see G. A. Knight and D. Kim, ‘International business competence and the contemporary firm’, *Journal of International Business Studies*, vol. 40, no. 2 (2009), pp. 255–73. Also: O. Burgel, G. Murray, A. Fier and G. Licht, *The Rapid Internationalization of High Tech Young Firms in Germany and the United Kingdom*: *A Summary Report for the Anglo-German Foundation for the Study of the Industrial Society* (2000).

50 S. C. Collinson, *Small and Successful in Japan: A Study of 30 British Firms in the World’s Most Competitive Market* (London: Avebury Press/Ashgate Publishing Group, 1996).

51 E. Beleska-Spasova and K. W. Glaister, ‘The geography of British exports: country-level versus firm-level evidence’, *European Management Journal*, vol. 27, no. 5 (2009), pp. 295–304.

52 J. A. Mathews and I. Zander, ‘The international entrepreneurial dynamics of accelerated internationalization’, *Journal of International Business Studies*, vol. 38, no. 3 (2007), pp. 387–403.

53 Ibid.

54 J. W. Liu and P. W. Beamish, ‘The internationalization and performance of SMEs’, *Strategic Management Journal*, vol. 22 (2001), pp. 565–86.

55 S. McGaughey, D. Welch and L. Welch, ‘Managerial influences and SME internationalization.’ In I. Bjorkman and M. Forsgren (eds.), *The Nature of the International Firm* (Copenhagen: Handelshojskolens Forlag, 1997), pp. 165–88.

56 S. Collinson and J. Houlden, ‘Decision-making and market orientation in the internationalization process of small and medium-sized enterprises’, *Management International Review*, vol. 45, no. 4 (2005), pp. 413–26.

57 B. Cassiman and E. Golovko, ‘Innovation and internationalization through exports,’ *Journal of International Business Studies*, vol. 42, no. 1 (2011), pp. 56–75.

58 K. D. Brouthers and G. Nakos, ‘SME entry mode choice and performance: a transaction cost perspective’, *Entrepreneurship Theory and Practice*, vol. 28, no. 3 (2004), pp. 229–47.

59 S. C. Collinson, *Small and Successful in Japan: A Study of 30 British Firms in the World’s Most Competitive Market* (London: Avebury Press/Ashgate Publishing Group, 1996).

BIBLIOGRAPHY

Ambos, Björn and Håkanson, Lars. 'The concept of distance in international management research', *Journal of International Management*, vol. 20, no. 1 (2014).

Buckley, Peter J., 'The impact of the global factory on economic development', *Journal of World Business*, vol. 44, no. 2 (2009), pp. 131–43.

Buckley, Peter J. and Casson, Mark C. 'The internalization theory of the multinational enterprise: a review of the progress of a research agenda after 30 years', *Journal of International Business Studies*, vol. 40 (2009).

Cavusgil, S. Tamer and Knight, Gary. 'The born global firm: an entrepreneurial and capabilities perspective on early and rapid internationalization', *Journal of International Business Studies*, vol. 46, no. 1 (2015).

Chandra, Yanto, Styles, Chris and Wilkinson, Ian F. 'An opportunity-based view of rapid internationalization', *Journal of International Marketing*, vol. 20, no. 1 (2012).

Chen, Shi-Fen S. 'Extending internalization theory: a new perspective on international technology transfer and its generalization', *Journal of International Business Studies*, vol. 36, no. 2 (March 2005).

Chittoor, R. and Jena, D., 'Ranking India's transnational companies', *ISB Insight*, vol. 11, no. 1, (2013), pp. 5–13.

Ciravegna, Luciano, Lopez, Luis and Kundu, Sumit. 'Country of origin and network effects on internationalization: a comparative study of SMEs from an emerging and developed economy', *Journal of Business Research*, vol. 67, no. 5 (2014).

Collinson, Simon and Morgan, Glenn. *The Multinational Firm (Images of Business Strategy)* (Chichester/Hoboken, NJ: Wiley, 2009).

Collinson, Simon and Rugman, Alan M. 'Relevance and rigour in international business teaching: using the CSA–FSA matrix', *Journal of Teaching in International Business*, vol. 22, no. 1 (2011).

Coviello, Nicole, Kano, Liena and Liesch, Peter. 'Adapting the Uppsala model to a modern world: Macro-context and microfoundations', *Journal of International Business Studies* vol. 48, no. 9 (2017).

Da Silva Lopes, Teresa. 'The entrepreneur, ownership advantages, and the eclectic paradigm', *Multinational Business Review*, vol. 18, no. 2 (summer 2010).

Eden, Lorraine and Li, Dai. 'Rethinking the O in Dunning's OLI/eclectic paradigm', *Multinational Business Review*, vol. 18, no. 2 (summer 2010).

Falahat, Mohammad, Knight, Gary and Alon, Ilan. 'Orientations and capabilities of born global firms from emerging markets', *International Marketing Review*, vol. 35 (2018).

Ghemawat, Pankaj. 'Distance still matters', *Harvard Business Review*, vol. 79, no. 8 (2001), pp. 137–47.

Ghemawat, Pankaj.*The Laws of Globalization and Business Applications*, Cambridge University Press (2017).

Hennart, Jean-François. 'Down with MNE-centric theories! Market entry and expansion as the bundling of MNE and local assets', *Journal of International Business Studies*, vol. 40 (2009).

Hillemann, Jenny and Gestrin, Michael. 'The limits of firm-level globalization: Revisiting the FSA/CSA matrix', *International Business Review*, vol. 25 (2016).

Inkpen, Andrew. 'Strategic alliances', *The Oxford Handbook of International Business* (2 ed.) (2009). Oxford University Press.

Johanson, Jan and Vahlne, Jan-Erik. 'The Uppsala internationalization process model revisited: from liability of foreignness to liability of

outsidership', *Journal of International Business Studies*, vol. 40 (2009).
Lundan, Sarianna M. 'What are ownership advantages?' *Multinational Business Review*, vol. 18, no. 2 (summer 2010).
Narula, Rajneesh. 'Keeping the eclectic paradigm simple', *Multinational Business Review*, vol. 18, no. 2 (summer 2010).
Narula, Rajneesh, 'Exploring the paradox of competence-creating subsidiaries: balancing bandwidth and dispersion in MNEs', *Long Range Planning*, vol. 47, no. 1–2 (2014), pp. 4–15.
Narula, Rajneesh and Martinez-Noya, Andrea. 'International R&D alliances by firms: origins and development', in Daniele Archibugi and Andrea Filippetti (eds.), *The Handbook of Global Science, Technology, and Innovation* (Hoboken, NJ: Wiley-Blackwell, 2015), pp. 148–74.
Narula, R., and Santangelo, G. D. (2012). 'Location and collocation advantages in international innovation', *Multinational Business Review*, vol. 20, no. 1, pp. 6–25.
Narula, Rajneesh and Verbeke, Alain. 'Making internalization theory good for practice: The essence of Alan Rugman's contributions to international business', *Journal of World Business*, vol. 50 (2015).
Rugman, Alan M. 'Reconciling internalization theory and the eclectic paradigm', *Multinational Business Review*, vol. 18, no. 2 (summer 2010).
Rugman, Alan M. and Oh, Chang Hoon. 'Friedman's follies: insights on the globalization/ regionalization debate', *Business and Politics*, vol. 10, no. 2 (August 2008).
Rugman, Alan M. and Verbeke, Alain. 'Liabilities of regional foreignness and the use of firm-level versus country-level data: a response to Dunning *et al.* (2007)', *Journal of International Business Studies*, vol. 38, no. 1 (January 2007).
Rugman, Alan M. and Verbeke, Alain. 'Internalization theory and its impact on the field of international business.' In Jean Boddewyn (ed.), *The Evolution of International Business Scholarship: AIB Fellows on the First*

50 Years, Research in Global Strategic Management, vol. 14 (Bingley: Emerald, 2008).

Rugman, Alan M., Verbeke, Alain and Nguyen, Quyen T. K. 'Fifty years of international business theory and beyond', *Management International Review*, vol. 51, no. 6 (2011).

Verbeke, Alain and Yuan, Wenlong. 'A strategic management analysis of ownership advantages in the eclectic paradigm', *Multinational Business Review*, vol. 18, no. 2 (summer 2010).

Zander, Ivo, McDougall-Covin, Patricia and Rose, Elizabeth L. 'Born globals and international business: evolution of a field of research', *Journal of International Business Studies*, vol. 46, no. 1 (2015).

Chapter 3

MULTINATIONAL ENTERPRISES, INNOVATION AND COMPETITIVENESS

Contents

Objectives of the chapter

Innovation is what enables firms to maintain their competitiveness, survive and grow. It also goes hand-in-hand with internationalisation. Firm-specific advantages (FSAs), such as technology, brands or capabilities that can be used to compete effectively in other country markets, have to be adapted and developed to apply in different country contexts. Successful international expansion requires effective innovation.

The specific objectives of this chapter are to:

1. *Define* innovation and map out some innovation trends across firms and countries.
2. *Explain* how the resource-based view (RBV) and the VRIO framework connect innovation and competitive advantage.
3. *Understand* how dynamic capabilities underpin a capacity in firms to continuously innovate, alongside the R&D and technology development functions.
4. *Explore* different systems of innovation and the international dimensions of innovation.
5. *Examine* the MNE as a differentiated network, locating and linking different innovation activities in different locations.

ACTIVE LEARNING CASE

GE Healthcare in India: locally driven innovation

GE's Mac 400 is an ultra-portable electrocardiogram (ECG) which is made in India and has sold well locally, partly because it costs one-third of the price of an equivalent imported product. It is also light-weight, battery-operated, and easily serviced, making it ideal for India's rural areas where patients are far from specialist hospitals and power outages are common. The reason that the Mac 400 is so well suited to India is because it was conceptualised, designed and sourced, as well as manufactured, in India, all following local customer requirements.

GE employs over 13,000 people in India and exports over $1 billion in products and services. One of its major business divisions, GE Healthcare, has invested in local joint ventures and manufacturing plants since the beginning of the 1990s, to reduce costs and increase local sales. But it is only much more recently that it has devolved some of the responsibility, capability and resources to the local subsidiaries to pursue locally appropriate innovation.

The John F. Welch Technology Center (JFWTC) in Bangalore was established in 2000 and is GE's first and largest multidisciplinary Research and Product Development Center outside of the United States. It collaborates with GE's four other R&D facilities that form the GE Global Research team (in New York, Munich, Shanghai and Rio de Janeiro) to conduct R&D for all of GE's businesses worldwide. With over 5,000 employees and over 1,000 patents to its credit, it has hosted a range of technology development projects from train engines and aviation turbo fans to baby warmers in the healthcare field. These investments, together with the organisational and cultural changes underpinning the devolution of power and resources to the local management in India, are beginning to pay dividends. GE Healthcare's Global revenue is over US$19 billion, with the Indian subsidiary projected to reach a revenue of over $1 billion by the year 2020. To accomplish this goal, the company announced in 2016 that it would double its investment in India. The subsidiary is increasingly seen to be an important part of GE Healthcare as India's economic growth translates into increased buying power and better healthcare provision. At the same time, GE's India-based R&D efforts are creating products that are being sold globally. Of the first 7,500

Mac 400s that GE Healthcare had sold, about 2,000 had been bought by Indian customers; the rest had been bought by customers in other country markets.

The drivers that underpin the focus of healthcare product innovation in India, including accessibility, quality and low cost, apply to other developing and emerging markets. So new products designed and developed in India are likely to sell well in these markets. This has been termed 'low-cost' (or 'frugal') innovation (Prabhu and Radjou, 2015) and 'innovation for the bottom-of-the-pyramid' (Prahalad, 2006). By allowing local management to drive innovation, GE is able to target this rapidly growing market segment globally. Success in one market segment can, however, create challenges elsewhere. The fact is that products like the Mac 400 have the potential to significantly undercut more expensive (and profitable) products sold in more advanced markets like Europe and the United States. This leaves GE with a potential problem of its own making: new products from its emerging economy subsidiaries may increasingly 'cannibalise' the firm's existing products in its more advanced markets.

Source: J. Prabhu and N. Radjou, *Frugal Innovation: How to Do More with Less* (London: Economist Books, 2015); V. Govindarajan, 'On: innovation, strategy, global business: 10 tips for creating distinct-but-linked innovation groups', *Harvard Business Review* blogs (2010), at: http://blogs.hbr.org/govindarajan/2010/08/10-tipsfor-creating-distinct-.html; N. Mahajan-Bansal and M. Goyal, 'Finger on the pulse, at last', *Forbes India*, at: http://www.forbes.com/2009/12/09/forbes-india-ge-healthcare-jeff-immelt-john-flannery.html; C. K. Prahalad, *The Fortune at the Bottom of the Pyramid: Eradicating Poverty through Profits* (Philadelphia, PA: Wharton School Publishing, 2006); 'Reverse innovation: GE makes India a lab for global markets', 20 May 2010, in *India Knowledge@Wharton*, at: http://knowledge.wharton.upenn.edu/india/article.cfm?articleid=4476; http://www.ge.com/in/company/factsheet_in.html; GE Innovation timeline at: http://www.ge.com/innovation/timeline/index.html.

1. **Does GE Healthcare have competitive advantages in India? In what ways are they sustainable?**

2. **In what ways is GE's Mac 400 ECG the result of 'local-for-local' innovation?**
3. **What indications are there that the Mac 400 ECG has become an example of 'local-for-global' innovation? How can this become a challenge for GE?**

INTRODUCTION

As we have discussed in Chapter 2, the key to a firm's competitiveness lies in its firm-specific advantage (FSAs). FSAs come in many different forms, as Chapter 2 has also discussed. FSAs, however, need to be continuously upgraded, and this requires firms to be innovative. Innovation more broadly speaking can be thought of as 'the successful exploitation or commercialisation of new ideas'. An expanded definition is: 'the renewal and enlargement of the range of products and services and the associated markets; the establishment of new methods of production, supply and distribution; the introduction of changes in management, work organisation, and the working conditions and skills of the workforce.'[1]

Chapter 1 made the point that innovation and technology are related. The stock of all innovations is regarded as being knowledge (of which technology is a subset). An asset that provides an advantage to company A today may not necessarily do so tomorrow, because competitor B may develop similar assets that compete with A's assets directly, or even make A's assets redundant. This does not have to be a radically new activity: if the competitor's product, process or service can substitute for A's product, process or service at a lower price, this may erode A's FSAs. Innovation and competitiveness are deeply interrelated, and in many instances the ability to innovate determines the competitiveness of both firms and countries.

Therefore, firms (whether uni-national or multinational, small or large) have to continuously seek ways of doing (at least) the same thing better for less money. FSAs do not have to be unique, but they do have to provide an *advantage* to the firm, relative to other firms.

Firms can also sell the same product or service at a higher price: but they do have to convince the customer that theirs is a better product or service, and this may be about learning how to better market their product. The ability to market a product successively is also a significant FSA. One of the reasons Apple is able to charge a premium for its products is the perception that its advertising and marketing have created of being a ‘cool’, ‘must have’ brand. Furthermore, creating and maintaining a reputation is also an FSA. Indeed, it is not uncommon for firms to have their marketing and R&D departments deeply intertwined.

Entrepreneurship and **innovation** also go hand-in-hand. Entrepreneurs, whether they are working in small or large firms, as owner-managers or employees, are distinctive because they have the capability and motivation to pursue potential opportunities for which they are able to assemble the appropriate complementary resources to create a successful business. They are willing to pursue opportunities that are riskier and more radical than normal. They are able to identify such opportunities and assemble the resources and capabilities needed to create value.

The success of firms comes from continuously learning and innovating. All firms, regardless of their size, have to innovate to survive. However, firms do not innovate within a bubble. They are embedded in specific locations, and they have to interact with the environment in which they are embedded. The capacity to learn depends upon the location advantages/CSAs of their environment. The fundamental key to all creativity comes from the quality of people that the firm employs, and these are a function of the quality of the universities, polytechnics and schools, as well as the education policies of the government. It also depends upon the innovation policy chosen by the government, because countries (and regions within countries) give various incentives to attract and encourage firms to be innovative, whether through formal R&D or through other informal

processes. As we shall discuss later in this chapter, the interaction of FSAs and CSAs underlies the competitiveness of firms, and because countries are sovereign, the policies of governments matter. MNEs are by definition located in many different places, and this FSA–CSA interaction needs to be appreciated and understood in each location. One of the key advantages of being an MNE is the ability to take advantage of different opportunities within its portfolio of locations.

Politicians are interested in maintaining and upgrading the location advantages of their country, region or city, and are increasingly interested in attracting the most innovative (and the most competitive) MNEs to choose their country and region. There is a *network effect* at work here: the more innovative firms there are in a specific location, the more attractive it is as a destination. Having high-quality knowledge infrastructure and human capital attracts more FDI. Countries monitor the quality of their location advantages continuously, and in this chapter we will take a look at one specific framework used to do so: the *systems of innovation* framework. This is not the only approach available; and Chapter 10 discusses CSAs and their relationship to competitiveness through other, complementary approaches.

Therefore, where firms locate innovation-related activities is of growing interest to managers, policy-makers and international business researchers. Moreover, the ways in which multinational firms link and integrate inputs (specialist knowledge, capabilities and ideas as well as assets and other resources) from various locations and connect these with market opportunities elsewhere is an increasingly important part of the 'performance puzzle'. The management of innovation and the location of innovation activities not only differentiate firms in terms of their performance, but have a significant impact on foreign direct investment flows and patterns of regional employment and development. In the first section of this chapter, we discuss and highlight the key trends in innovation

at both the firm and country level. We then look at the resource-based view and introduce the VRIO framework, which is a useful tool to identify the FSAs that allow the firm to have a competitive advantage. Building upon the resource-based view of the firm, we introduce dynamic capabilities and look at how successful firms develop and maintain their competitive advantages in rapidly changing environments, driven by an increase in competition and technological advances. The next part of the chapter discusses the connection between FSAs and CSAs. The latter part of the chapter will introduce the work of Bartlett and Ghoshal (and their various co-authors) on the location of innovation activities and discuss how international innovation is about finding the right balance between integration and local responsiveness.

TRENDS IN INNOVATION AT THE COUNTRY AND FIRM LEVEL

The data on knowledge infrastructure and innovation at the country level mirror the evidence presented in Chapter 1. The developed countries still dominate the production of knowledge- and technology-intensive (KTI) industries which indicates their superior ability to compete in world markets. These industries consist of knowledge-intensive service industries (such as commercial business and financial services), as well as high-technology manufacturing (such as aircraft and pharmaceuticals) and medium-high-technology manufacturing industries (such as motor vehicles and parts). **KTI industries** accounted for one third of the world's gross domestic product (GDP) in 2016.[2]

The KTI share of the world's developed economies grew from 29 per cent to 32 per cent between 1997 and 2012.[3] This was due mostly to increases in commercial and public services, continuing a movement away from manufacturing and towards services. The KTI activity in the developing world has also been growing over the last years. Indeed, we have seen economic growth in many emerging countries, such as Brazil, Turkey and South Africa. More specifically, the rise of China among KTI exporters is notable with its KTI share being comparable to that of larger, developed countries.

China's rise in KTI exports is mainly driven by its dominance in high-tech manufacturing, which represents an important sub-category of KTI industries, as previously discussed. Global exports of high-technology goods were equal to $2.6 trillion in 2016 and are largely dominated by ICT products.[4] Figure 3.1 shows the output of high-technology manufacturing

industries, indicating China's rapid rise with its output now exceeding that of the EU. Indeed, between 2003 and 2016, China's high-technology manufacturing rose more than fivefold, resulting in its global share climbing from 8 per cent to 24 per cent in 2016. Despite this shift, the United States remained the largest global provider of high-technology manufacturing (31 per cent of the global total in 2016).

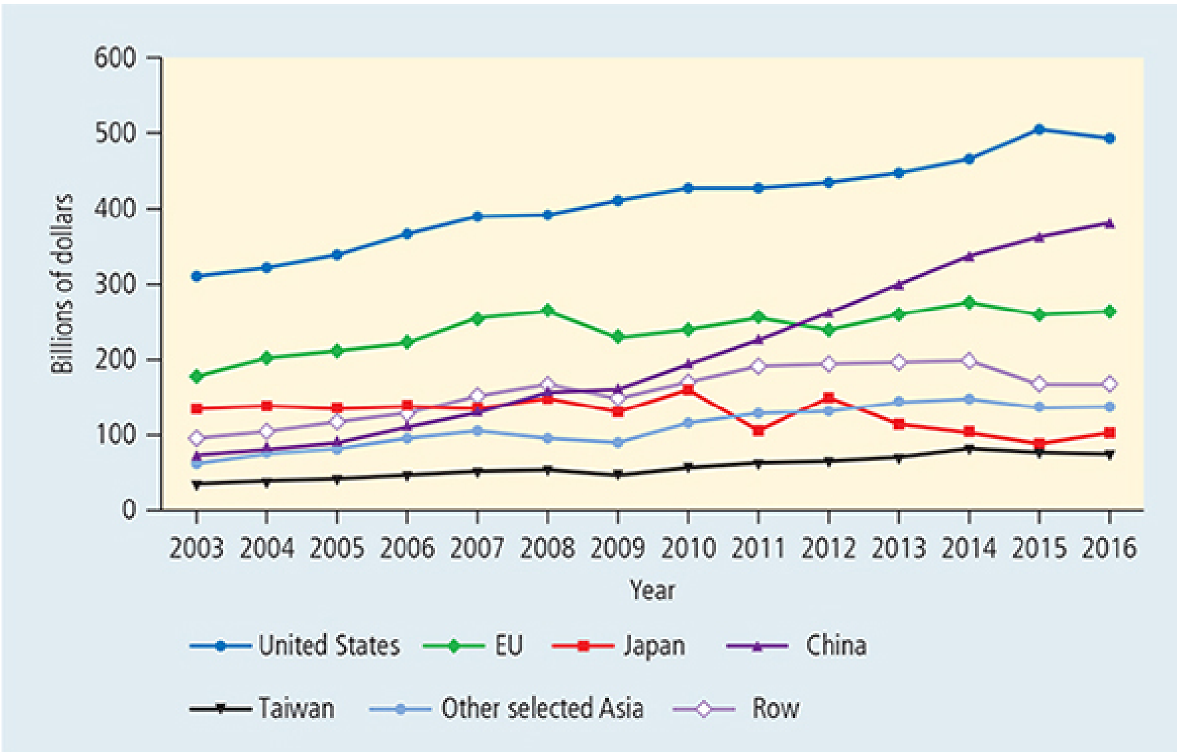

Figure 3.1 Output of high-tech manufacturing industries for selected economies, 2003–16

Source: IHS Global Insight, World Industry Service database (2017). Science and Engineering Indicators 2018 (National Science Board).

Note: Output of high-tech manufacturing is on value added basis. Data are not available for European Union members, Cyprus, Estonia, Latvia, Lithuania, Luxembourg, Malta and Slovenia; Row = rest of the world

In terms of R&D expenditures are also dominated by the Triad and more recently China (Figure 3.2). Notably, the top eight R&D-performing countries (the United States, China, Japan, Germany, South Korea, France,

India and the United Kingdom) accounted for almost 75 per cent of the global R&D expenditure with the United States ($476 billion), China ($371 billion) and Japan ($171 billion) spending the most. Although absolute expenditures on R&D have been growing, the share of the developed countries declined in the last decade. For example, the US share declined from 40 per cent in 2000 to only 28 per cent of the global total in 2015, while the EU share dropped from 27 per cent in 2000 to 22 per cent in 2015. On the other hand, countries in East and South East Asia, such China, India, Japan, Malaysia, Singapore, South Korea and Taiwan all saw an increase in their combined share from 25 per cent in 2000 to 40 per cent of the global total in 2015.

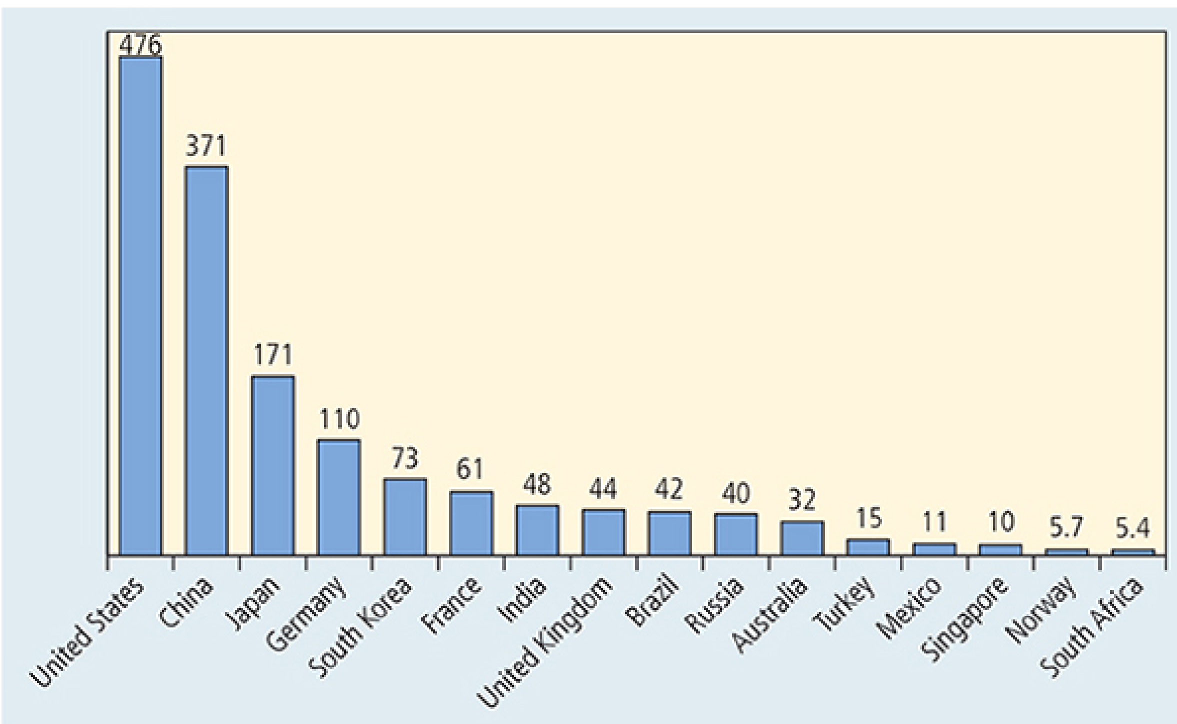

Figure 3.2 Global R&D expenditures in $ billions by selected countries

Source: Author's creation based on data extracted from the UNESCO Institute for Statistics (UIS). See http://uis.unesco.org/apps/visualisations/research-and-development-spending/ (last accessed: 23 November 2018).

R&D expenditures and availability of R&D personnel (see Figure 3.3.) are important measures of the innovation *input*. On the other hand, patents are an important measure of *output* of R&D. Not all patents become commercialised or lead to innovations, but they provide a good measure of the strength of the innovative capacity of firms. They are also indicative of innovation in knowledge and technology-intensive industries, and tend to exclude low-tech sectors where firms do not normally patent because the costs of filing a patent do not justify the effort. Similarly, they may not be an indicative measure for SMEs as these firms tend to rely on less formal innovation efforts.[5] As Table 3.1 shows, US patents granted tend to be dominated by the developed countries with the United States dominating, followed by Japan. Table 3.2 shows a selected list of the largest developing economies in US patenting between 2000 and 2015.

Denmark	10555
South Korea	8808
Norway	8357
Germany	8017
Slovenia	6909
United Kingdom	6382
Russia	5573
China	2763
Morocco	1149
Chile	928

Figure 3.3 R&D personnel per million people for selected countries, 2016

Source: Author's creation based on data extracted from the UNESCO Institute for Statistics (UIS). See: data.uis.unesco.org (last accessed: 23 November 2018).

Table 3.1 USPTO patents granted, by location of inventor, 2006–15

Years	United States	Japan	EU	Other developed countries	Developing countries
2006	102267	39411	26742	23900	1422
2007	93690	35941	25030	23890	1491
2008	92001	36679	25378	26156	1611
2009	95038	38066	25785	27562	1722
2010	121178	46977	33406	35183	2423
2011	121257	48256	33384	36708	2635
2012	134194	52773	38605	40707	3273
2013	147666	54170	43165	44902	4339
2014	158713	56005	46933	48982	5135
2015	155982	54422	46883	51702	5651

Source: Author's creation using data from the Patent Technology Monitoring Team Report issued by the USPTO (December 2015).

Note: Patent counts by country and year – all patent types. Developed countries classified as high-income countries by the World Bank. Developing countries classified as upper-and lower-middle-income countries and low-income countries by the World Bank.

Table 3.2 Selected list of major developing economies in US patenting, 2010–15

Country	2010	2011	2012	2013	2014	2015
Newly developed countries						
Taiwan	9636	9907	11624	12118	12255	12575
South Korea	12508	13239	14168	15745	18161	20201
Singapore	633	696	841	857	1010	1048
Developing countries						
Brazil	219	254	256	286	362	381
Mexico	115	117	153	204	222	203
India	1137	1259	1734	2474	3044	3415
China	3301	3786	5335	6597	7921	9004
South Africa	142	144	158	181	181	199
Turkey	45	52	55	83	103	136

Source: Author's creation using data from the Patent Technology Monitoring Team Report issued by the USPTO (December 2015).

✔ Active learning check

Reflect on Figure 3.2 and 3.3 (either alone or with a partner).

What do these figures tell us? What are the requirements for being an ’innovative’ country?

Does it matter for GE India to have a large pool of R&D personnel to chose from? Yes, of course. However, while India can offer some excellent personnel in this area, GE as a global employer can also bring in R&D personnel from abroad, including its home country, the United States.

Building up FSAs is about both internally upgrading and learning (as we shall discuss in this chapter) through formal and informal R&D. R&D expenditure by firms measures the systematic and planned upgrading and augmentation of FSAs through laboratory work, and in collaboration with external suppliers and partners. It is no accident that the most innovative firms are often the ones that are most aggressive about internationalising. Figure 3.4 shows the world’s largest and most aggressive patenting firms. Note that IBM, one of the most innovative and competitive MNEs in the world, registered more patents than most countries in a six-year period. For example, China-based firms were awarded 44,744 patents during the same period. Similarly, notice how in Figure 3.5 we see only a few changes with notable recent players such as Google and Amazon making the list. Overall, the data suggests the ‘members-only’ nature of patenting which largely rests on its high capital investment requirements. Indeed, the amounts being spent on innovation by these firms is incredibly large. Figure 3.6 provides an overview of the top spenders on R&D in 2017, with investments reaching amounts of up to two-digit billions. For example, consider the investments made by the Swiss pharmaceutical company, Novartis. Developing a new

pharmaceutical drug can cost upward of $100 million. This is because R&D is not only about scientists working in a laboratory, but also includes testing of the drug, which requires trials on animals and human beings in order to ascertain the drug's efficacy and side-effects. Getting regulatory approval of these trials is expensive and time consuming. To take another example, GSK's malaria vaccine took 30 years to develop, at a cost of more than $565 million by 2015.[6]

Not all products and services are equally expensive to develop, of course. Incremental innovation refers to improvements in existing products and services, which are less risky and cost less. Such 'upgrades' may come through user experience and market- and customer-led feedback, and are often driven as much by marketing as much as through scientific work. This is certainly the case with most software products: Microsoft Word is a result of a series of incremental upgrades. New applications may be discovered for 'older' discoveries. For example, the chemical 'Teflon' was first discovered in 1938 by Roy J. Plunkett, an employee at famous MNE DuPont. Initially trademarked by the company in 1945, the new discovery found its use within the US military who used the chemical for artillery shell fuses. However, with the war coming to an end, the company sought to introduce the chemical into consumer products. With some important amendments, these efforts eventually resulted in the creation of the non-sticky cookware consumers love today.

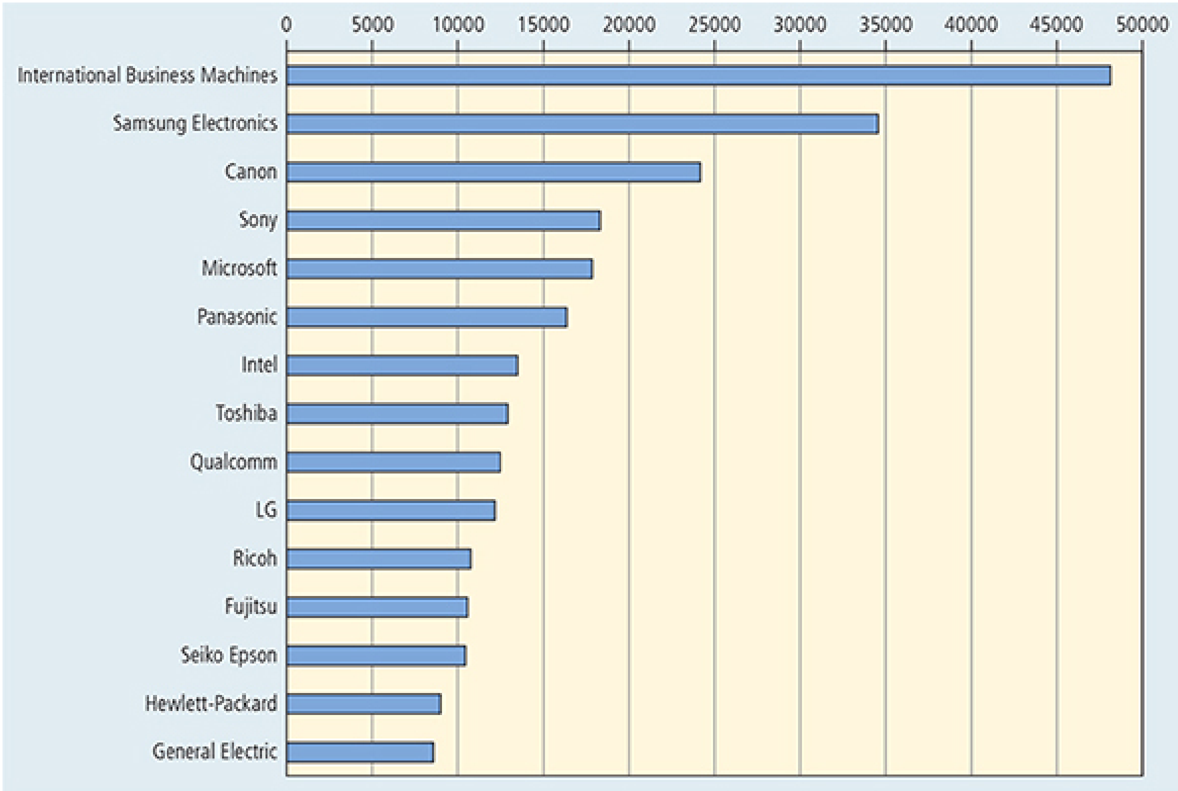

Figure 3.4 Top US patent recipients, 2010–16

Source: Author’s creation using data from the USPTO (available until 2015) and ifi claims patent services (used for 2016 figures).

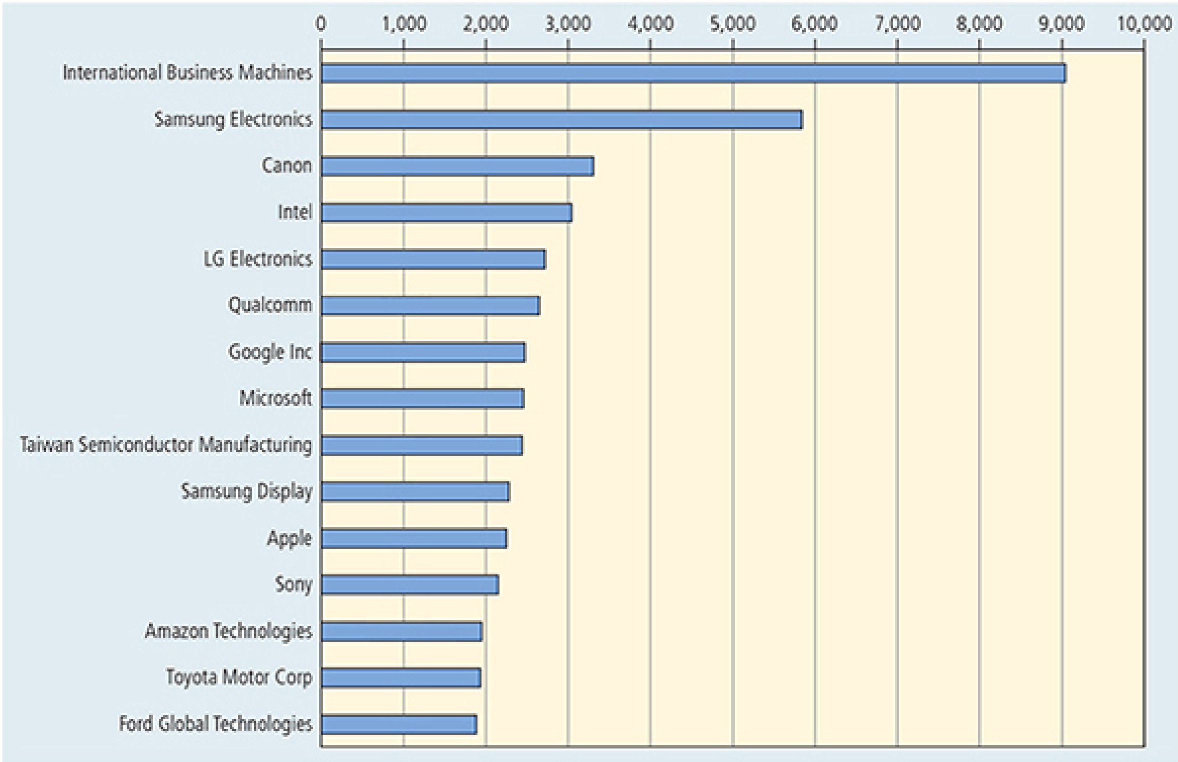

Figure 3.5 Top 15 US patent recipients, 2017

Source: Author's creation based on data from ifi claims patent services and Statista.com (2017).

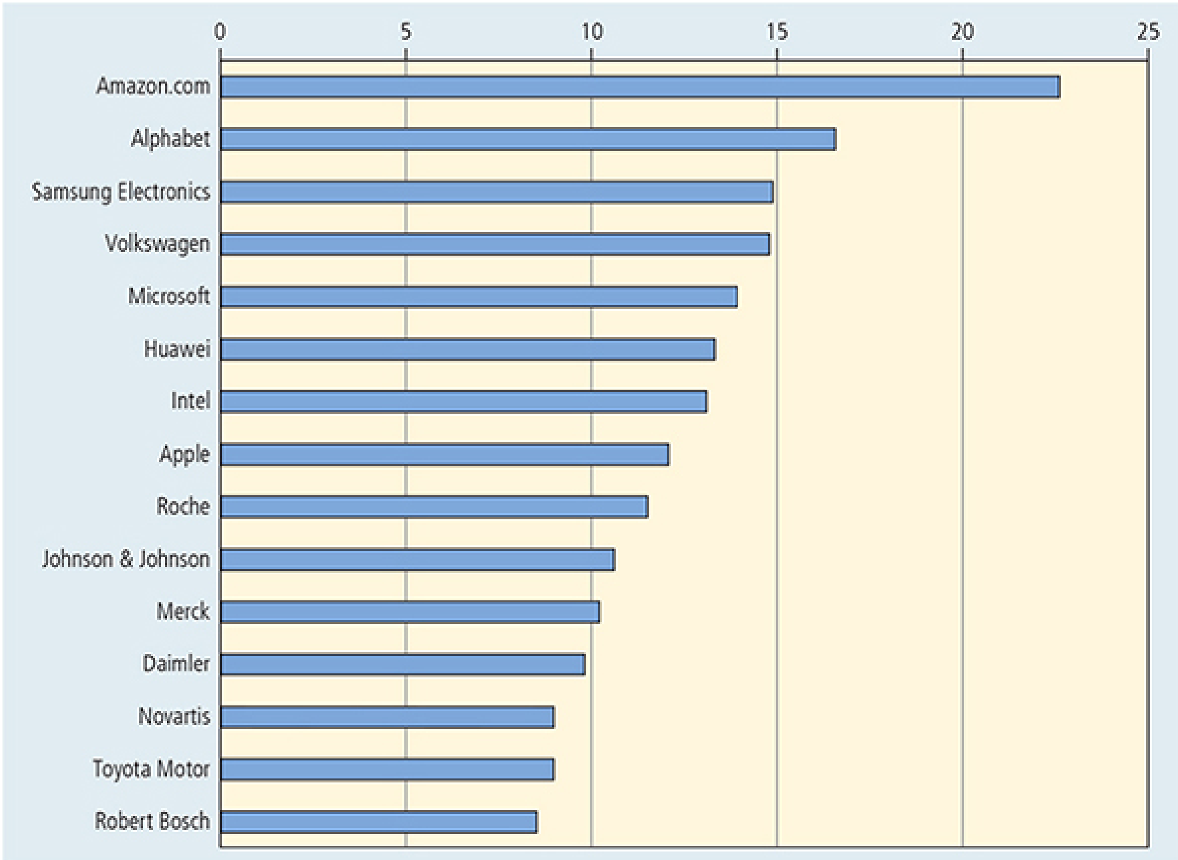

Figure 3.6 **Top 15 spenders on R&D in $ billions, 2017**

Source: Author's creation based on data from Bloomberg, company reports. For more information, see www.bloomberg.com.

Note: Amazon reports spending on 'technology and content', not R&D.

People often imagine R&D departments as being places with lots of people in white labcoats, or a bunch of software programmers sitting in front of computer screens in a laboratory. Farmers have developed new strains of crops, or new ways of increasing the fertility of their land by trial and error; new kinds of fish hooks are developed (and sold) by enthusiastic fishermen. Names such as Thomas Edison, Steve Wozniak and Nicola Tesla are examples of brilliant people who were professional inventors that generated new ideas and products without being employed by a firm (often in a proverbial garage). However, such independent inventors are rare, and

although many people do tinker away in their free time, the majority of such innovations are often incremental and also sporadic, and firms have come to rely on systematic experimental efforts by dedicated teams of specialists, rather than the intendent inventor to sustain the flow of innovations.

Building and staffing R&D laboratories means that innovation is costly, and the more radical the innovation, the greater the risk – if a new product or service is costly to develop, and if the product or service fails to capture sufficient sales, it can easily bankrupt the firm. Firms, therefore, seek to reduce the cost of R&D by a variety of means, including greater use of collaborative agreements or strategic alliances with a variety of partners. For instance, GSK's malaria vaccine would not have come to market had not the Gates Foundation, a non-profit organisation, provided about half the cost of the R&D in the form of grants. Strategic alliances are themselves risky, as we shall also later discuss in this chapter.

On the one hand, since costs are high, MNEs are continuously in the search for cheaper inputs while also searching for ways to increase their creativity. Therefore, they are always searching their environment (and therefore their location advantages) not only at home but also in their various host countries, for new and unique inputs. On the other hand, firms suffer from a deep inertia. They do not and cannot (and will not) change their location or their linkages with their external partners rapidly. Change is costly and, as we discussed in Chapter 1, institutions change only very slowly.

THE RESOURCE-BASED VIEW (RBV) AND THE VRIO FRAMEWORK

Resources and capabilities

Understanding that FSAs can provide a competitive advantage requires us to consider the resource-based view (RBV). The RBV argues that the idiosyncratic, immobile strategic resources owned or controlled by a firm are its source of competitive advantage.[7] Each firm has a different mix of resources/competences and resource/competence gaps, and its strategic responses to these allow for the possibility of different paths to growth and internationalisation,[8] and consequent heterogeneity in the international performance of the firm.[9]

One of the key strategic challenges in international business is the alignment of the firm-specific resources and capabilities (FSAs) with its host country environment (CSAs). To choose the best strategy, managers need to understand which resources in a firm create value and how they can sustain and develop that value creation. We will discuss this in greater detail later in the chapter.

First, we will explain the nature of resources and capabilities. ‘Resources’ and ‘capabilities’ are two different things (Table 3.3).[10] Resources are what a firm draws upon to create value. They may be considered as the ‘raw material’ upon which capabilities are built. Capabilities are the firm’s ability to create, modify, reconfigure and leverage resources. Essentially, it is the bundling of the resources that builds capabilities. Resources are not necessarily firm-specific, while capabilities are firm-specific and are the basis of FSAs.[11]

Not all resources and capabilities have equal strategic importance or the potential to be a source of sustainable competitive advantage for a firm. The VRIO framework has been proven to provide a sound guidance in identifying the FSAs that can provide a competitive advantage.

The VRIO framework

Firms possess tangible and intangible assets, such as the firms' plant and equipment, training, experience, coordinating systems, and formal and informal planning. Nevertheless, not all attributes owned by firms will help them to develop value-creating strategies – in other words, only the ones that enable firms to increase or improve their efficiency and effectiveness are considered as strategically relevant resources. Therefore, *firm resources* can be any organisational process, assets or knowledge owned by firms that allow them to generate and apply strategies in order to improve their efficiency and effectiveness.

Table 3.3 Firm-specific resources and capabilities

Resources	
Tangible resources	• Financial assets: cash, stocks, loans • Physical assets: land, buildings, equipment, natural resources • Human capital: knowledge, skills, managerial know-how
Intangible resources	• Intellectual property: R&D knowledge, patents, copyrights, trademarks • Reputation: brand, corporate goodwill, formal and informal networks and relationships • Customer/supplier portfolio: exclusive contracts • Organisational culture: values, norms, tradition
Capabilities	

R&D and innovation capabilities	• R&D skills in new product and service development • Innovative organisational skills
Operational capabilities	• Process efficiency: Six Sigma, just in time, lean manufacturing
Marketing capabilities	• Market knowledge and responsiveness • Product development • Communication
Sales and distribution capabilities	• Sales skills and knowledge • Innovative sales channels • Efficient distribution model
Corporate management capabilities	• Strategy development and implementation structure • Leadership • Risk management
Dynamic capabilities	• Organisational ability to respond and adjust to internal and external shifts

Before exploring the VRIO framework, it is important to define the concepts of *competitive advantage* and *sustainable competitive advantage*. A firm has a competitive advantage when it applies a value-creating strategy not being utilised by existing or potential competitors. For this competitive advantage to be sustainable, competitors must not be able to replicate the strategy and the benefits originating from it.

In opposition to previous approaches used to understand the sources of sustainable competitive advantage for firms, such as SWOT analysis, this

model is based on the assumption that firms have *tangible* and *intangible* resources that are not perfectly mobile and not homogeneously distributed across competitors. In other words, firms' resources are *heterogeneous* and *immobile*.

The VRIO framework is a theoretical model based on the resource-based view (RBV) that helps to understand the sources of sustainable competitive advantages.[12] To hold the potential of sustainable competitive advantage, the firm's resources must fulfil four criteria: they must be valuable (V), rare (R), imperfectly imitable or inimitable (I), and properly organised (O). The VRIO framework is summarised in Figure 3.7.

Valuable resources

Value can be determined by answering the question: *Do a firm's resources and capabilities add value by enabling it to exploit opportunities and/or neutralise threats?*[13] A resource can only be a source of sustainable competitive advantage when it adds value to the firm. A valuable resource helps the firm to exploit opportunities and nullify or overcome threats in the environment in which it operates. In other words, a valuable resource will allow firms to enhance their effectiveness and efficiency. Some examples of valuable resources are the organisational culture of 3M that prioritises creativity, the Walt Disney brand name or Marks & Spencer's freehold ownership of the majority of its stores. In all those cases, the ownership of valuable resources allows the firms to operate more efficiently, more cheaply, or in a more effective way than its competitors.

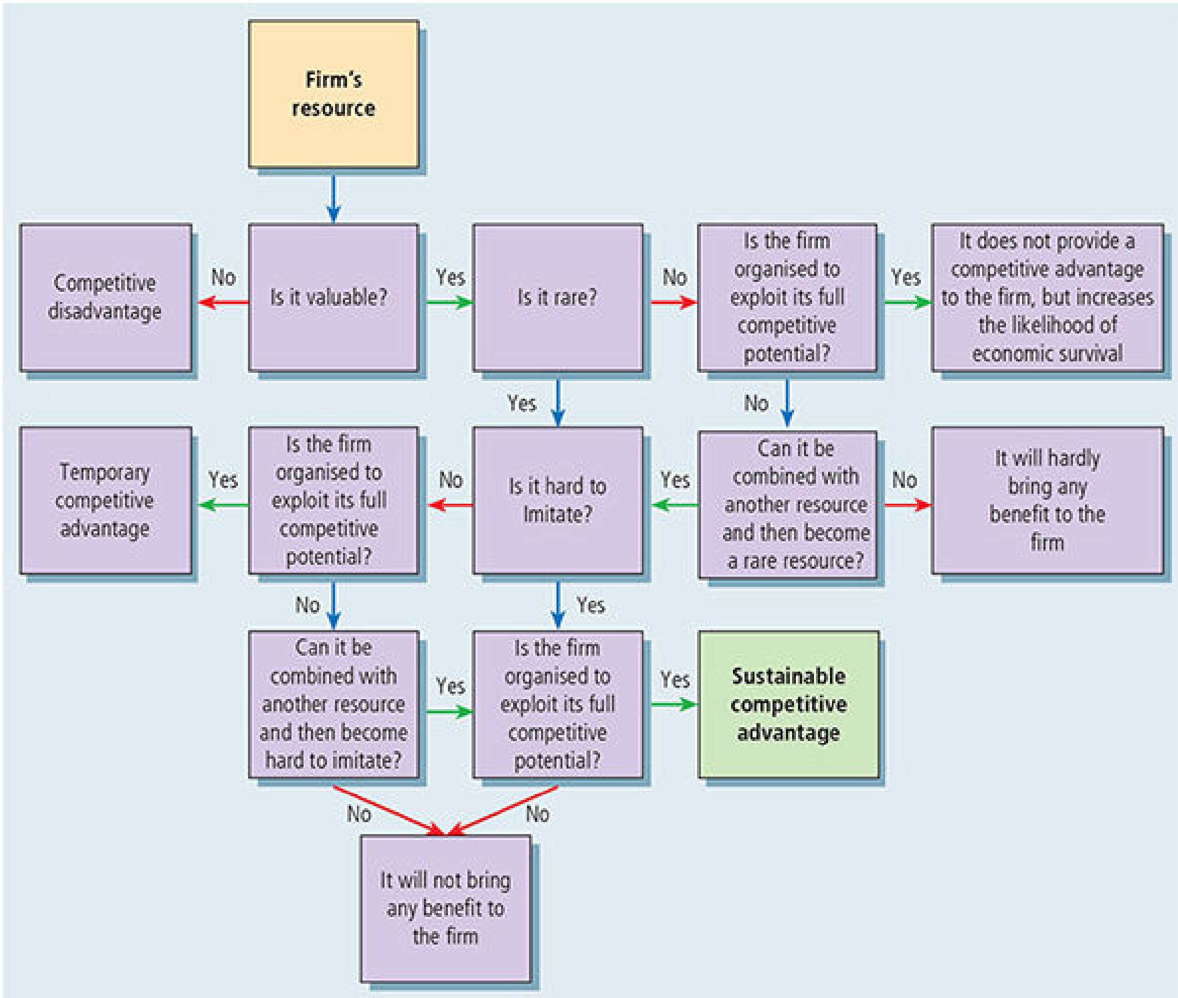

Figure 3.7 The VRIO framework: a decision-making process

Sources: Adapted from J. Barney, "Firm resources and sustained competitive advantage," *Journal of Management*, vol. 17 (1991); J. B. Barney, "Looking inside for competitive advantage," *Academy of Management Executive*, vol. 9, no. 4 (1995).

It is worth noting that changes in the environment, such as changes in technology or customers' taste, may affect the value of resources over time. For instance, IBM's capabilities in mainframe computing became less valuable in the 1990s, with the spread of personal computers. IBM was fortunate that the internet era made mainframe machines valuable as they form the basis of internet servers. They were able to leverage the basic concepts developed for IBM AS400 series in 1988 to meet the continuing

demand for stable and secure enterprise servers which today form the backbone of cloud computing. Therefore, managers should continuously verify whether the firm's resources continue to add value considering the environmental changes. The question of value combines both the external environment (opportunities and threats) and the firm's internal conditions (resources and capabilities).

Rare resources

Rarity can be addressed by answering the question: *How many competing firms already possess these valuable resources and capabilities?*[14] If several firms own a similar asset, all of them will exploit this asset in a similar way. Therefore, it will cease to provide a sustainable competitive advantage for any of them. A sustainable competitive advantage requires the implementation of a value-creating strategy dissimilar to that of competitors. It implies that, to be a source of sustainable competitive advantages, a firm's resources must be rare among competing firms. An example was the Walmart's point-of-purchase inventory control system, which was no longer a source of sustainable competitive advantage once it had been imitated by Kmart. Similarly, while today falsely associated with Apple, the first 'smart phone' was actually created by IBM in the early 1990s. The initial rare resource of touchscreen technology became obsolete as a source of competitive advantage with the introduction of the iPhone in 2006. This also highlights the increasing importance of intangible assets, such as branding, which competitors may struggle to compete with.

In real life, it is very unlikely that a firm's resources can be truly unique, and it is hard to determine whether a competitor's version of the same resource are equivalent to, or inferior. Firms rarely have objective information about the tangible and intangible assets of their competitors, since such information is often uncodified, embedded in routines, equipment

and brands, embodied in individuals, and guarded jealously.[15] Indeed, the superiority of a technology or a specific knowledge asset over a rival's version is hard to judge, even after close examination. Besides, it is even difficult to value one's own assets – how much is a brand name really worth? Comparison is difficult even where knowledge is codified – for instance, in a patent. Thus, the question that arises is: how rare must a valuable resource be in order to generate sustainable competitive advantage? Unfortunately, there is no straight answer to this question. In general, the firm's resources must be rare in comparison to its major competitors' resources.

Imperfectly imitable resources

Imitability can be addressed by answering the question: *Do firms without a resource or capability face a cost disadvantage in obtaining it, compared to firms that already possess it?*[16] The possession of valuable and rare resources can be considered as a first-mover advantage, rather than a sustainable competitive advantage, if competing firms can easily imitate or purchase them. A new design for a dress or a suit is easily imitable. You can be sure that the designs of Hugo Boss or Louis Vuitton presented at the Paris fashion shows this year will find their way to the products of other brands by the following year. The imitation of resources may occur by the duplication of the resource, or by the use of substitute or strategically equivalent resources that are no more costly than the resources used by the firm that is being imitated.

Four motives make the firm's resources hard to imitate: (1) unique historical conditions; (2) when the link between the firm's resources and its sustainable advantages is not intuitive (causally ambiguous), because of daily 'small decisions' concerning the development and exploitation of the resources; (3) when the firm's resources are socially complex, such as the

firm's reputation or its relationship with suppliers; and (4) enforceable intellectual property rights protection, such as a trademark or patent.

Organisation

Organisation can be addressed by answering the question: *Is a firm organised to exploit the full competitive potential of its resources and capabilities?*[17] A firm may have a resource that is valuable, rare and hard to imitate, but if the managers are not able to make appropriate use of it, it will not bring any benefits to the firm. The firm must be organised in order to exploit the benefits of its resources. The important components of a firm's organisation are: compensation policies, formal reporting structure, and management control systems. None of those components can by itself generate sustainable competitive advantages. However, when combined with other resources or capabilities, they allow the firm to exploit the full potential of its competitive advantages. For instance, the lack of organisational resources prevented Xerox from exploiting the potential of several innovations (resources) developed at its research laboratory Xerox PARC, in Palo Alto. Likewise, although almost everybody recognises Tesla's automobiles to be innovative, there is considerable concern that the company does not possess the organisational skills and managerial capabilities to produce these cars affordably. More specifically, Tesla's ambitious strategy to become a mass market leader has been overshadowed by difficult production challenges of its Model 3. Elon Musk himself referred to this as 'production hell'. [18]

In summary, the resource-based view states that the development and sustainability of a firm's competitive advantages rely on its tangible and intangible resources, which must be heterogeneous and immobile and present four attributes: value, rarity, imitability and organisational aspects. It is worth noting that, when a resource lacks one of the VRIO attributes, such

as rarity, it may be combined with another resource that will add the missing quality, in this case rarity, to the old resource. The ability to combine resources is related to the concept of recombinant FSAs, explored in Chapter 2.

✔ Active learning check

Review your answer to Active Learning Case question 1 and make any changes you like. Then compare your answer to the one below.

1 Does GE have competitive advantages in India?

The best way to analyse this question is through the VRIO framework.

Value: *Do a firm's resources and capabilities add value by enabling it to exploit opportunities and/or neutralise threats?* YES

GE Global Research is well embedded in the firm.

Rarity of resources: *How many competing firms already possess these valuable resources and capabilities?* NOT MANY

As pointed out above, this is hard to assess, but very few organisations are of the same size, and have the same market experience and global presence as GE. Moreover, not many firms are able to invest as much in R&D as what GE does.

Imitability: *Do firms without a resource or capability face a cost disadvantage in obtaining it compared to firms that already possess it?* YES

With GE having over 1,000 patents, if they are utilised in their products, it means that their products are hard to imitate. However, given that some patents may expire, it will be important for GE to come up with new ones to sustain its superior position.

Organisation: *Is a firm organised to exploit the full competitive potential of its resources and capabilities?* YES

GE has extensive experience of innovation and marketing products, and has a highly educated workforce (over 50 per cent of its staff in the Indian R&D plant have either a Ph.D. or a master's degree).

DYNAMIC CAPABILITIES

Increasing competition and fast technology change in virtually all industries has led scholars to explain how firms need to develop and maintain competitive advantages. As Figure 3.4 showed, companies such as IBM, Samsung and Sony have accumulated a large stock of valuable technological assets and proprietary knowledge by following a 'resource-based strategy'. However, just the possession of valuable resources is not enough to explain the competitive advantages of these firms. Firms may have an extensive stock of valuable resources, but still have just a few effective capabilities. For example, even though Kodak owned a large portfolio of valuable patents, it was unable to continue to compete in the marketplace, filing for bankruptcy in 2012 and selling its patents for $525 million as part of its restructuring.[19] Thus, patents on their own are a resource, similar to someone owning a car: unless you utilise the resource efficiently to generate an income they are not an advantage or capability.

Firms must continue to sustain and augment their competitive advantage if they are to survive. Nokia was unable to do so in the mobile phone industry, even though they owned a large patent pool as a resource. They were unable to leverage this key resource to respond to the evolving market. Understanding how firms can sustain their competitive advantages while responding to environmental changes is a very ambitious goal, one that involves multiple levels of analysis, including the external environment, the firm's portfolio of FSAs, and how the organisational structure facilitates or hinders managerial decision-processes. Addressing this issue is one of the biggest challenges of the strategic management field.

To be successful in the global market, firms need to possess capabilities to manage internal and external resources – that is, resources owned by the firm, or external resources the firm can access and/or use – that allows the firm to respond to environmental and technological changes. Competitive advantage, broadly speaking, results from the ownership of proprietary assets that are efficiently combined with value creating activities, and that are difficult for competing firms to replicate. Over the long term, however, competitive advantage (and the returns associated with it) tends to be eroded either through the depreciation of assets or by their imitation by rival firms. Moreover, new entrants with innovative substitutes may enter the stage, making the focal firm's products or service less competitive. For example, consider technology firm Uber entering the taxi industry, offering lower prices to customers and thereby gaining important market share. Importantly, this example highlights that firms may lose their competitive advantage to rivals that operate beyond their industry spans. Therefore, to maintain competitiveness, firms must continuously upgrade their resource reservoir by integrating and reconfiguring internal and external assets in tune with dynamic business environments, as well as with firm strategy. Such upgrading requires **dynamic capabilities** that are, by nature, highly tacit, hard-to-imitate and path dependent since they are embedded in a unique set of relationships and histories of the firm. The dynamic capabilities framework stresses organisational and managerial competences that can enable firms to achieve and maintain competitive advantage even in a (rapidly) changing environment (Teece, 2007).

Dynamic capabilities are different from ordinary capabilities.[20] Ordinary capabilities are unlikely to be sufficient to maintain competitive advantages over time. For long-term growth and sustainable competitive advantages of the MNE, dynamic capabilities to extend, modify, augment and upgrade its

unique asset base are needed. Dynamic capabilities, therefore, undergird the future of any MNE.[21]

At the centre of the dynamic capabilities concept is the entrepreneurial pursuit by firms to discover and capture opportunities in various national markets, and continuously create and upgrade FSAs to sustain competitiveness in complex and volatile global business environments.[22] Dynamic capabilities are especially relevant to international firms because they can better access and utilise global assets required to augment their FSAs. MNEs are usually in a strong position to tap into resources and capabilities from multiple local contexts and integrate them to create a range of competitive advantages. Indeed, one of the key motivations of MNEs to expand abroad is asset-augmenting (Chapter 2), and dynamic capabilities are closely associated with recombinant type FSAs.

Agility is key if a firm is to respond in a timely fashion to environmental changes. They must be sensitive to existing and potential new opportunities and threats, act quickly after an opportunity (or threat) is identified, and be able to efficiently manage their resources in order to maintain the firm's competitiveness. Firms need three main types of dynamic capabilities in order to respond to changes or new challenges: *quick learning*, the effective *integration of new assets/processes*, and the ability to *modify or transform existing assets/processes*.

Quick learning/incremental learning

Firms acquire knowledge by exploring in the vicinity of their existing knowledge assets, undertaking routines that lead to incremental innovations (*learning-by-doing*). Knowledge is acquired by the firm's interaction with its external environment. It may take place through interaction with customers, suppliers, competitors or government agencies. In general, firms are averse

to radical change, in that they are likely to ‘stay close’ to patterns of behaviour, learning and interaction that have been successful in the past.

At a conceptual level, this is known as *incremental learning*. At a more operational level, it means that firms must also be quick to learn. Suppose a firm faces a new problem, for instance an unexpected error in the production process that stops the production line. The technical team may propose possible solutions. The proposed solutions may not work at first. However, after several attempts and modifications to the original solution the team discover a particular solution that proves effective in restarting their production line. When a successful solution reaches this point of ‘maturity’, it becomes the ideal approach to be used every time the same problem occurs. The continuous use of the same solution will then become an organisational routine. The action of proposing and testing new solutions for problems, and going through an extensive process of trials, is how firms learn in most circumstances, and is described as routinised or *incremental learning*. This is how the knowledge of a firm is translated into its organisational routines or processes. However, it is not only new internal problems that lead firms to ‘learn-by-doing’. Firms may try new approaches when faced by environmental challenges, threats, technological changes or new opportunities. This process of learning can be enhanced by the partnership with external actors, such as competitors or research centres, which can add different and complementary knowledge to the firm’s existing resource base.

Integration of new assets/radical learning

The building of new assets is also fundamental to firms and it may occur by the combination (or recombination) of internal resources, the combination of internal resources with external resources, or even the combination of only external resources that the firm can assess and utilise. This highlights the

importance of recombination FSAs (Chapter 2). From an international business perspective, internal resources include FSAs not only from headquarters, but also from subsidiaries located elsewhere. Likewise, the external resources include not only complementary home country specific assets, but also assets from the countries where subsidiaries are located (host countries). The combination may be between existing assets, between new assets, or between existing and new assets. This requires the firm to consider new and 'radical' alternatives that are outside its existing paradigms.

Radical learning and applying new ideas requires a high degree of organisational efficiency from the firm, since it needs to be able to see the internal and external assets in a holistic fashion and, at the same time, recognise assets that, when combined, can be a source of competitive advantage. The efficient and effective integration and coordination of resources determines the firm's performance. Radical learning and the creation of major technological or organisational breakthroughs is no straightforward process, and is often associated with basic research. Basic research is undertaken by a few very large firms that can afford to take a long-term time horizon, and by dedicated research centres and universities. Such inventions rarely have immediate commercial value, and are almost always at least a decade away from commercialisation. This is the reason why radical learning tends to be dominated by large organisations with deep pockets who can afford to make long-term investments. For instance, developing quantum computers is mainly dominated by a handful of research-intensive universities and research centres, as well as large MNEs such as IBM and Google.

Modification and transformation of new organisational assets

The success of firms relies not only on the development of new asset-type FSAs through radical learning, but indeed depend mainly on the

enhancement or transformation of their existing asset base, including those associated with organisational routines (transaction-type FSAs). The ability to identify dysfunctional routines is essential to firms' operation in high-velocity markets. Nevertheless, changing existing routines is neither easy nor costless. First, firms suffer from what is called organisational inertia. Organisations are constituted of individuals, who have a tendency to do things in the same way they have always been done, often resisting change. They also much prefer incremental change to radical change. Second, the improvement or transformation of resources is costly. Therefore, firms need to develop low-payoff changes as well as implementing strategies to ensure that the changes are effective.

Dynamic capabilities and small firms

The dynamic capabilities approach has also been seen as a useful conceptual and analytical framework for understanding small, adaptable firms. Because of their relative lack of financial and human resources, and their need to respond quickly to temporary opportunities, such as new-technology waves or consumer fads, dynamic capabilities and organisational agility are even more important to the survival and success of such firms.[23]

The popular stereotype of a successful, fast-growing, high-tech start-up helps illustrate the importance of dynamic capabilities. They are the focus of attention partly because they are seen as the ideal-type of wealth-creating organisation, but also because they are seen to hold lessons for other kinds of firms, large and small, looking to improve their responsiveness and innovativeness. Developing dynamic capabilities is important for start-ups, if they want to overcome their 'limitedness of smallness'. These firms must leverage their advantages of agility and flexibility, as well as their entrepreneurial employees to sense and seize opportunities in the market.

Dynamic capabilities relate to the processes by which, and the success with which, small firms learn to grow and adapt to changing threats and opportunities in their surrounding competitive environment. This includes a heightened ability to sense external changes that present new threats or opportunities and the strategic and organisational flexibility to adapt to these. Smaller firms do not have the luxury of ‘missing the boat’, since they typically have a few products or services. Should they fail to identify important external changes and act on them, they risk the survival of the firm. Larger firms can better afford to fail to respond in one area, because their product portfolios tend to be larger.

Dynamic capability theories refer to ‘search and selection’ capabilities alongside ‘configuration and deployment’ capabilities. Together these enable firms to orchestrate co-specialised assets, including outside knowledge and expertise, in a continuous way to maintain alignment with this changing environment. Such orchestration is akin to recombination-type FSAs. Firms with these FSAs are quicker at creating, extending and modifying resources and assets to maintain competitive advantages, relative to firms with fewer dynamic capabilities.[24]

Studies of dynamic capabilities in firms of all sizes refer to the concept of capability life cycles. These depict how firms need to periodically renew their capabilities as they expand and evolve, either through internal upgrading and/or via acquisitions, joint ventures and other kinds of external alliances. Failure to renew increases the dangers of other, newer, or faster firms developing capabilities that underpin superior competitive advantages.[25]

There are obvious parallels with Darwinian evolutionary theory and indeed dynamic capabilities approaches draw extensively from concepts such as ‘requisite variety’, ‘selection and retention’ and ‘evolutionary fitness’, and from the work of evolutionary economists, such as Joseph

Schumpeter. Schumpeter coined the term ‘creative destruction’ to refer to the process by which superior new ways of doing things continually usurp old ways in an inevitable cycle of renewal. Schumpeter identified innovation as the critical dimension of economic change, contrary to the popular theories of the day, and placed the entrepreneur at the centre of his view of economic systems.[26]

INTERNATIONAL BUSINESS STRATEGY IN ACTION

Spreadshirt: open innovation

In March 2001, a student in Leipzig (Germany) called Lukasz Gadowski developed an online company for designing and selling t-shirts. He was joined by Matthias Spiess, who financed the initial phase of the start-up, and by January 2002, 100 online affiliate ventures or 'partner shops' had joined from around the world. Despite the enterprise being judged an 'unrealistic business model' at the Cologne Business Plan Competition, 500,000 shops had joined by mid-2008 and the 'Spreadshirt' company had made history. As of 2017, with over 4.8 million products shipped to more than 160 countries, Spreadshirt has become a world-leading e-commerce platform for consumers who demand custom printing of clothing and accessories.

The company's goal is to be 'The creative apparel platform, inspiring people to create, buy or sell individualised fashion.' It has an unusual business model, with customers playing the roles of buyers, sellers and designers. They can buy customised t-shirts, hoodies, jackets, bags or accessories directly from the online store. Whether they are individuals or corporate customers, they can also sell via the Spreadshirt online platform by setting up a shop. Firms like CNN, Holiday Inn, Nissan and *The Sun* newspaper in the UK have done this to sell their own branded designs. But individual entrepreneurs anywhere in the world can also offer customised clothing through their own Spreadshirt shop website, while Spreadshirt takes care of inventory management, manufacturing, logistics, payments and other aspects of customer service for their partner shops. This allows designers to sell their own designs without the investment required to establish their own full-service companies. Providing the capability for individuals to design one-off shirts without the need to set up a shop now makes up 40 per cent of Spreadshirt's business.

Spreadshirt also runs 'laFraise', Europe's largest t-shirt design competition, whereby each week designers from all over the world put forward their latest creations and the Spreadshirt community votes for the best. Winners get prizes as well as having their designs printed and sold globally. This is 'crowd sourcing', effectively outsourcing the complex decision regarding which, out of hundreds of design options, a company should print and try to sell. By manufacturing a limited set of designs, a producer benefits from significant economies of scale and higher profits, but this

requires a process for selecting the most popular designs. Rather than trying to assess this through market research, Spreadshirt and its ‘designer-seller-customers’ use crowd sourcing.

Spreadshirt’s primary activities take place via a range of online networks. It is both global and local in a way that firms with business models based on fixed assets can never be. As partner shops join and leave, the firm’s international portfolio of ‘resources’ and its online profile in country markets change. But it does also have a physical presence of branch offices and customer service centres in France, Britain, the United States, Spain, Ireland, Italy, Poland, Brazil, the Czech Republic, Norway, Switzerland, Canada, Italy and the Netherlands, to support its head office in Germany.

Despite being the European market leader in its field, and being active in 19 different markets, as of 2017 Spreadshirt had a limited number of employees (750) and outsourced the ‘physical’ aspects of its business on behalf of customers. For example, during the financial year of 2017, the company received more than 30,000 new designs from its customers. On the other hand, manufacturing, logistics, and supply chain management, and even elements of its marketing are done via contracts with other firms. The firm has half-a-million partner shops, around 80,000 active selling partners and millions of customers worldwide. Global revenues grew from €15.3-million in 2007 to €107 million in 2017. With its headquarters in Leipzig, Germany, the company has two subsidiaries in the USA, one in Boston (MA) and one in Greensburg (PA).

Source: http://eu.techcrunch.com/2010; http://www.spreadshirt.com; http://www.spreadshirt.co.uk; J. Krisch, ‘Spreadshirt swaps CFO; makes 21 million euro revenue’, optaros.com blog (18 August 2009). https://www.spreadshirt.co.uk/newsroom/dates-figures/.

INNOVATION AND LOCATION ADVANTAGES

Creating FSAs not only depends upon the internal R&D activities of the firm. Innovation inside a firm is highly reliant on the external environment of the firm, as we briefly discussed in Chapter 2. Resources within the firm need to be converted into capabilities, but both the resources of the firm and the quality of the capabilities that are generated rely on resources that are outside the firm – in other words, the location advantages/CSAs.

Location advantages and firm-specific advantages differ in one primary aspect: FSAs are resources that are controlled by the firm, while location advantages are available in principle to all. It is the *internalisation* of L advantages that creates FSAs.

Innovation, therefore, is highly dependent on this interaction between FSAs and L advantages. The *process* of interaction between FSAs and L assets exists in every location. These processes are also broadly similar for all firms, regardless of nationality. The FSAs of firms in any given period tend to be a function of the home country's L assets (in the case of a uni-national firm). For MNE subsidiaries the interaction is between the FSAs available to the affiliate and its host country environment. To understand the initial FSAs that a firm uses to internationalise, it is useful to understand the industrial and economic structure of its home country. To understand how its FSAs evolve when the MNE sets up an affiliate in another country, it is important to examine the location advantages of its home and its host location.

Firms (and their subsidiaries) and their locational environment interact, and function as a 'system'. They are embedded through historical, social and

economic ties to other actors in the same location, and these constrain their actions. National contexts vary in terms of their economic, social, cultural, political and institutional characteristics, and this variety underpins both of these kinds of innovation opportunity. These factors influence the kinds of resources and capabilities that are available in a particular location and the kinds of customers and markets that develop there. Studies also show how different forms of competitive advantage at the national, industry and firm levels stem from the particular characteristics of the **systems of innovation (SI)**.[27]

The quality of local scientific, technological, design-related and creative expertise, combined with institutional relationships between enterprises, universities and government research organisations, underpins this competitiveness. Firms that evolve in regions with high-quality capabilities and institutions benefit from this by gaining competitive advantages that help them expand internationally. These location endowments also make such locations attractive to other firms engaged in FDI.

Figure 3.8 gives a stylised version of a conventional innovation system. An SI approach essentially allows us to map the complex interactions between a firm and its environment. The environment consists, firstly, of interactions between firms – especially between a firm and its network of customers and suppliers. Secondly, the environment involves broader factors shaping the behaviour of firms: the social, political and cultural context; the institutional and organisational framework; infrastructures; the processes which create and distribute scientific knowledge, and so on. By economic actors we refer to two groups. The first group are firms – private and public – engaged in innovatory activity, and the second consists of non-firms that determine the knowledge infrastructure that supplements and supports firm-specific innovation. The knowledge infrastructure consists of public research institutes, universities, organisations for standards, intellectual property

protection, etc. that enable and promote science and technology development. For simplicity, we can broadly define the non-firm sector as consisting of: (1) a public R&D sector including various organisations conducting R&D activities; (2) an education sector consisting of universities, institutes and other organisations providing training and education.

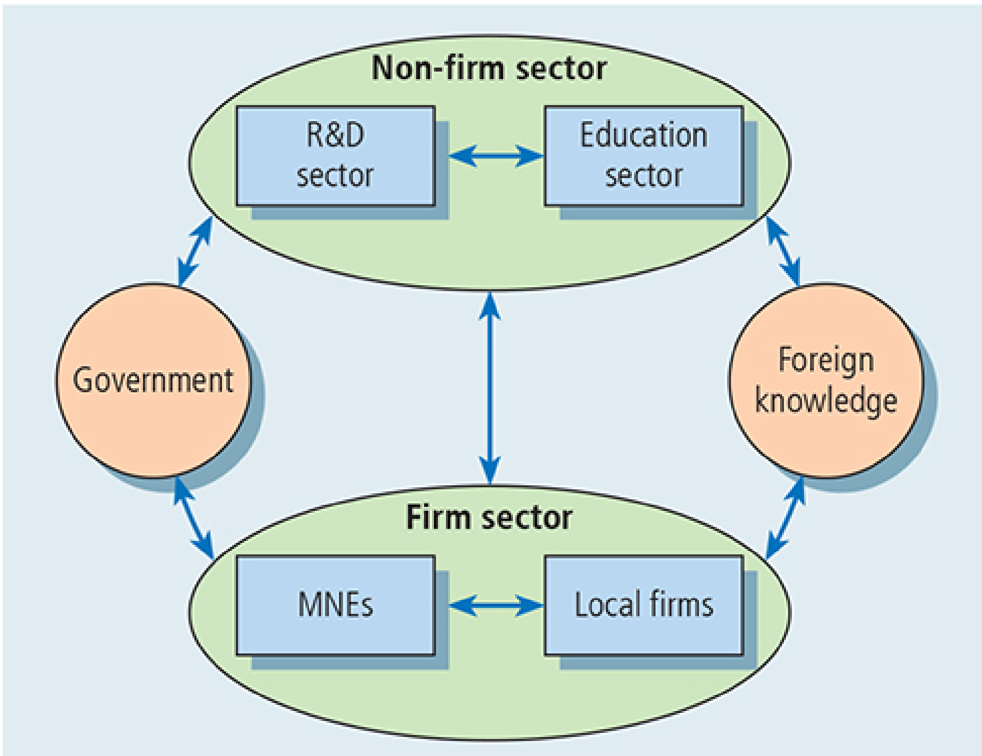

Figure 3.8 The conventional model of an innovation system

The interactions between the various actors within a system are governed by institutions, which we introduced in Chapter 1. Institutions are the ‘glue’ that binds the various actors together, and determines the efficacy of their interaction (or lack thereof). Institutions are taken here to be of two types, informal and formal, and are generally assumed to be the ‘sets of common habits, routines, established practices, rules, or laws that regulate the interaction between individuals and groups’.[28] Institutions create the milieu within which all economic activity is undertaken and establish the ground rules for interaction between the various actors. Formal institutions include

the appropriate intellectual property rights regime, competition policy, the creation of technical standards, taxation, the establishment of incentives and subsidies for innovation, the funding of education, etc. They are codified and are administered by organisations that are often established by governments. Such organisations are designed to create and implement new and existing formal institutions. They are generally politically defined and provide legally binding rules, regulations and institutions. Indeed, the political and economic spheres are rarely independent, and this is all the more so where a high degree of central planning was undertaken, whether in developing countries that implemented import substitution programmes, or in the former centrally planned economies. In general, the policy environment in which economic actors function has a high degree of interdependency between the economic and political spheres.

Informal institutions are rarely codified. They are also necessary for creating and promoting links between the various actors, are closely tied to norms and values, and represent routines which are essential to the implementation of formal institutions. To modify and develop informal institutions is a complex and slow process, particularly since they cannot be created simply by government fiat. Perhaps the most important aspect of informal institutions is the 'know-who'.[29] For firms, these informal networks of government agencies, suppliers, politicians, researchers, and so on take considerable effort and often years – if not decades – to create, but once developed, they have a low marginal cost of maintenance.

INTERNATIONAL DIMENSIONS OF INNOVATION

A major defining feature of multinational enterprises (MNEs) is that they manage business operations across a range of country contexts, each of which represents a different set of opportunities for innovation, in two specific ways. First, country contexts provide a distinctive set of market opportunities, which offer the potential for an MNE to sell customised products and services to particular groups of customers across a variety of market locations. Second, they offer a unique set of resources or inputs into the innovation process, including scientific and technological assets and capabilities, and expertise and knowledge in R&D, engineering or design, at a particular price. By continually linking innovation input opportunities and output opportunities, multinational enterprises, regardless of their size, are to a greater or lesser extent entrepreneurial.

Figure 3.9 outlines some of the main drivers for internationalisation in relation to innovation in MNEs. The two main forms of internationalisation, 'asset exploiting' and 'asset augmenting', were referred to in Chapter 2. Very often they go hand-in-hand because local specialists, whether engineers, plant managers, distribution specialists or customer-relationship managers, are usually the best equipped to customise processes, products and services to local conditions. Local assets and knowledge need to be leveraged to develop or adapt products and services for local customers.

Thus, in Figure 3.10, we show how an MNE with headquarters in one country is linked through its affiliates in other countries to the innovation systems of other countries. This may be because it is following its customers, and seeking to increase its market size. In this case, it will

transfer knowledge from the parent to the affiliates through reverse and direct knowledge transfer (Figure 3.10).

As discussed in Chapter 2, MNEs can also internationalise as a way to upgrade through asset-augmenting activities. Thus they will engage in 'reverse technology transfer', whereby MNEs undertake R&D abroad with the explicit intention of seeking and acquiring technological assets from the host country for use elsewhere in the MNE. Firms may engage in R&D in a foreign location to gain access to complementary assets that are location specific. That is, foreign technological activities aim explicitly to benefit from the innovation system of the host location.

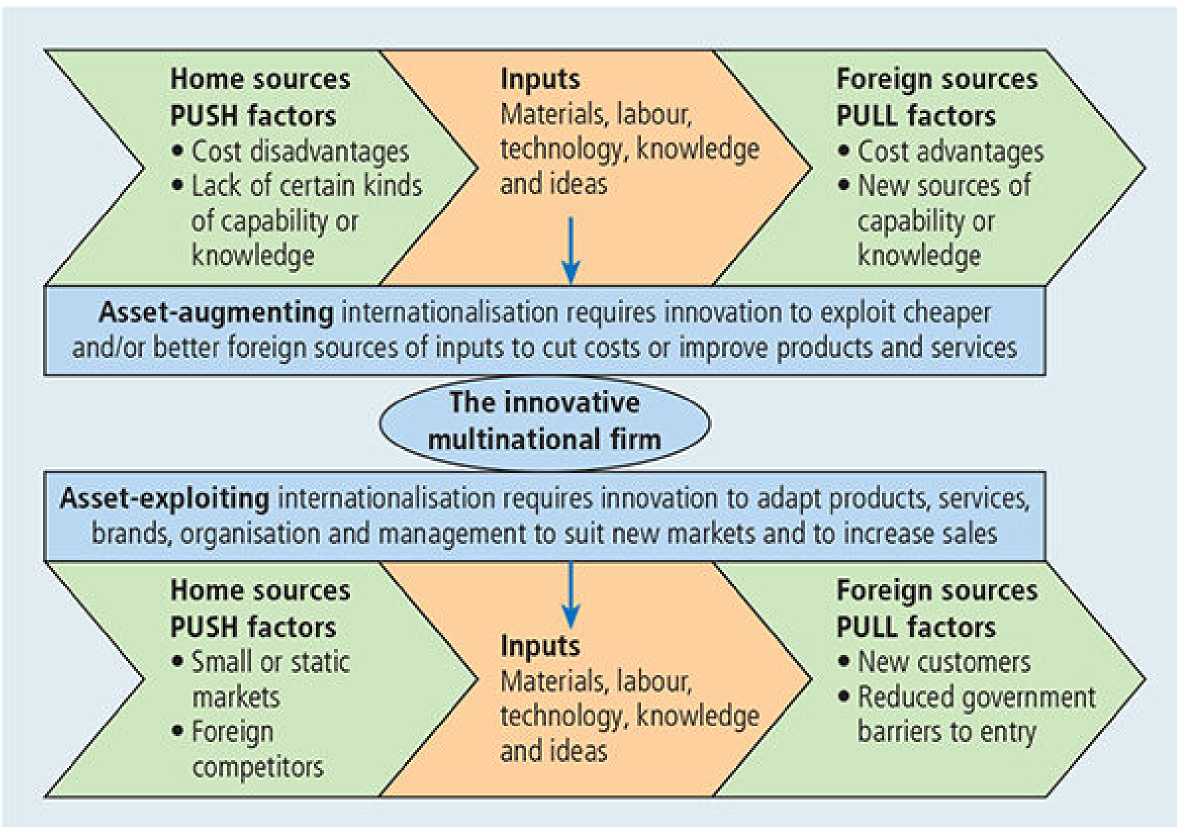

Figure 3.9 International dimensions of innovation

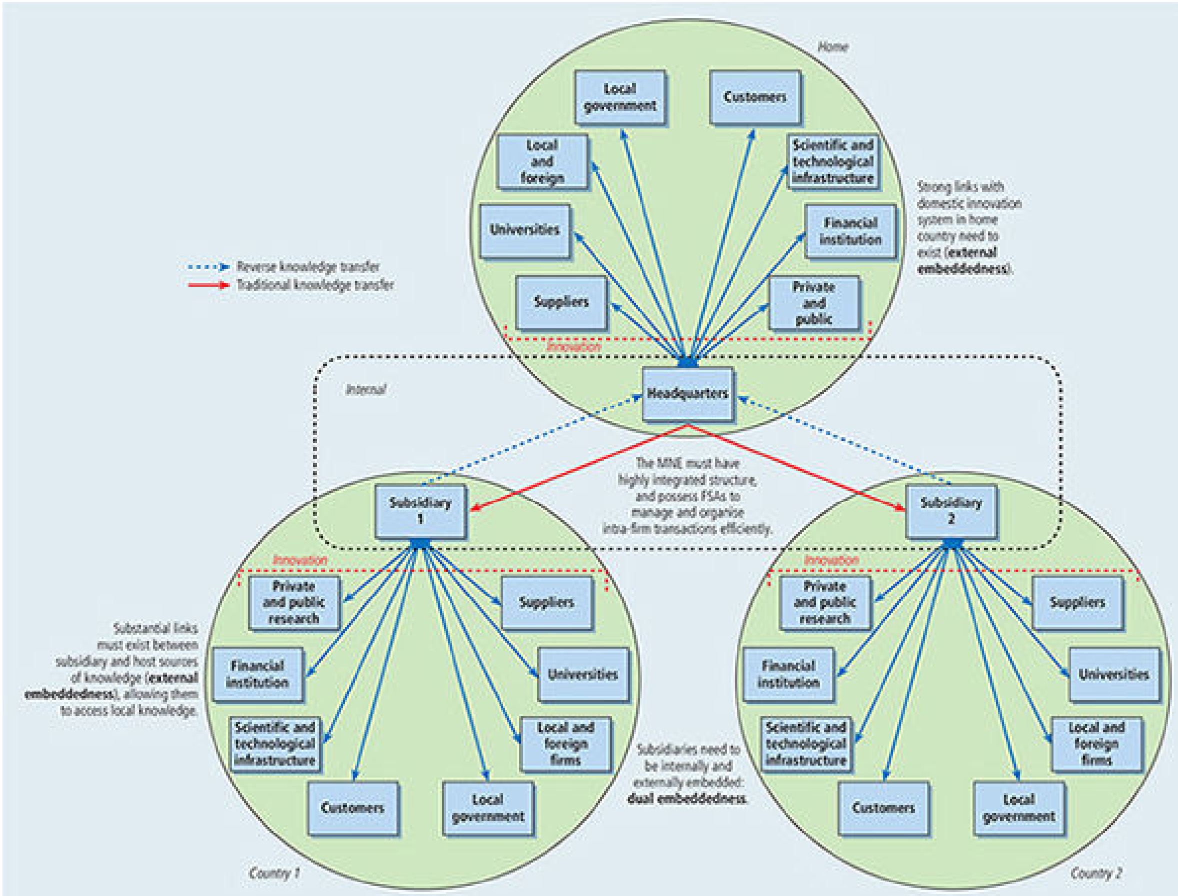

Figure 3.10 MNE headquarters linked through its affiliates in other countries to the innovation systems of other countries

It is worth noting that not more than 30 years ago, countries had innovation systems that could be described as ‘closed’. In the sense described in Chapter 1, they were poorly integrated into the global economy, and had few interdependencies with other actors in other countries. They engaged largely though trade, but experienced relatively little interdependence through FDI and intra-MNE flows. They were national systems of innovation because most linkages and interdependencies were based with the same country. Today few countries have closed systems. Of course, some innovation systems are more ‘national’ than others, and the term is indicative rather than definitive.

The sources of knowledge available in today's typical 'national' system are a complex blend of domestic and foreign ones. In some countries, it is increasingly difficult to separate foreign knowledge sources from domestic ones. MNE subsidiaries are sometimes so well embedded that they are regarded as part of the domestic environment. This reflects not just the length of time that these subsidiaries have been present (e.g., ABB's predecessors, ASEA and Brown-Boveri have been instrumental in building Norway's infrastructure for more than a century, and the merged firm is treated as a local actor by the Norwegian government), or the fact that the affiliate is jointly owned (e.g., Hindustan Unilever in India) or has been acquired (e.g., Reed Elsevier), but also the nature of the industry, and the growing trend towards consolidation in sectors with low growth and opportunities of global rationalisation (e.g., metals, banking, automobiles). MNEs of any given nationality with subsidiaries in several countries may have links with several different universities in several different countries, and may receive research subsidies from several national funding agencies.

THE LOCATION OF INNOVATION ACTIVITIES IN THE MNE

As discussed elsewhere in this book (see Chapter 10), multinational enterprises have to cope with the competing pressures of integration and responsiveness: that is, to derive benefits such as economies of scale from the integration and standardisation of their operations globally, while at the same time customising and adapting in response to local customers and contexts.

As shown in Figure 3.11, adapted from the ground-breaking work of Christopher Bartlett and Sumantra Ghoshal, innovation also features in this balancing act. In theory, some innovation activities should be centralised and/or standardised and some should be de-centralised and/or customised (or 'localised'). We find this is also the case in practice, as described below.[30]

A second framework, developed by Nohria and Ghoshal, extends this logic by describing several archetypal MNE structures for managing different kinds of innovation.[31] Figure 3.12 shows this basic typology, differentiating between three generic forms of innovation activity: sensing, responding and implementing. The framework shows how it may be appropriate either to separate or to combine these three activities, depending on industry conditions and the product or service in question.

In some industries, such as semiconductors, heavy engineering and pharmaceuticals, innovation is predominantly technology-driven, rather than market-driven. This is normally because the needs of customers are clear-cut (faster processors, stronger bridges or a cure for cancer) but difficult to achieve. Moreover, there are strong economies of scale in the centralisation of R&D and innovation efforts to achieve scientific or technological

breakthroughs ahead of competitors. Sensing opportunities for innovation, like new drug compounds to cure known diseases or faster semiconductor chip designs, and responding to these by allocating capital investment and putting together dedicated project teams, will tend to happen at one location. This specialist unit or 'centre of excellence' may also implement the innovation by developing and launching the product for sale around the world. This is referred to as **centre-for-global** in the framework, in cases where the new technology or product is developed centrally but can be used at the local level. Nohria and Ghoshal use the example of telecoms switching systems, which have clear-cut technology development drivers and obvious economies of scale in R&D, making it appropriate for firms to focus resources and efforts in central R&D units. These create fairly standard components which can be used in telecoms networks around the world.

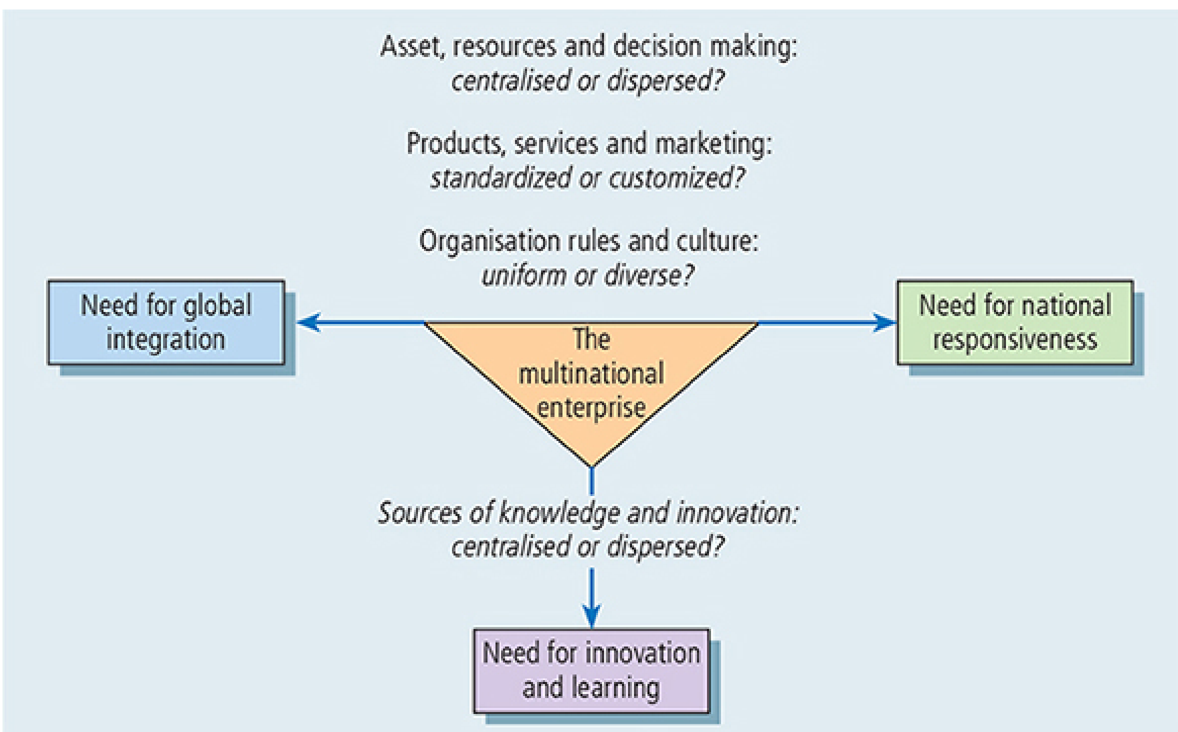

Figure 3.11 Structural, strategic and organisation dilemmas for the innovative multinational firm

Source: Adapted from C. Bartlett and S. Ghoshal, *Managing across Borders: The Transnational Solution* (Boston, MA: Harvard Business School Press, 2002).

Innovation structures across the MNE:	Where are different tasks carried out? Sense	Respond	Implement
Centrally for global operations	At the centre	At the centre	Across all global operations
Locally for local operations	In local subsidiary	In local subsidiary	In local subsidiary
Locally for global operations	In local subsidiary	In local subsidiary, with support from the centre	In local subsidiary, then across all global operations
Globally for global operations	Across many global subsidiaries	Across many global subsidiaries	Across many global subsidiaries

Figure 3.12 Global MNE structures for managing innovation

Source: Adapted from N. Nohria and S. Ghoshal, *The Differentiated Network: Organizing MNCs for Value Creation* (San Francisco, CA: Jossey-Bass, 1997).

For market-seeking internationalisation it may be appropriate for the local subsidiaries of a firm to sense the opportunity or need for product or service changes to suit local preferences. Headquarters may then allocate to these subsidiaries the discretionary decision-making powers and the resources and capabilities to respond to these opportunities and implement changes to existing products or services, for the local market. These are labelled **local-for-local** innovations, where new or customised products and services are entirely developed by local subsidiaries because they suit the specific characteristics of the local market or country conditions.

✔ Active learning check

Review your answer to Active Learning Case question 2 and make any changes you like. Then compare your answer to the one below.

2 In what ways is GE's Mac 400 ECG the result of 'local-for-local' innovation?

An R&D plant was set up to meet the demands of the local market. Medical products created through a process of 'frugal innovation' were needed because Indian customers have low average levels of disposable income. This is different from GE Healthcare's other markets. Indian engineers have experience in frugal innovation and so were best placed to meet the needs of the market. Devolving the product development project to local management was therefore appropriate. GE leveraged its global differentiated network of assets and capabilities to innovate efficiently and effectively.

Local-for-global is where a locally developed product or service turns out to fit other markets beyond the location of the subsidiary responsible for creating it. Nohria and Ghoshal describe how Unilever gave its Indian subsidiary the remit for developing a new kind of clothes detergent to improve sales across the country. Because many people in India washed clothes by hand, a local team designed a soap bar with the same properties as soap powders (which had the inconvenient tendency to drift downstream and wash someone else's clothes!). This became a big-selling brand in India and then proved popular in other developing countries for the same reasons.

The fourth typology, **global-for-global**, is seen as the 'ideal' organisation structure for 'transnational' corporations (as opposed to multinational corporations). Here firms pool inputs, including resources, knowledge and capabilities, in response to changing technological and market opportunities globally. By effectively coordinating their many subsidiaries around the

world, transnational companies can leverage the advantages of their size (scale advantages) and diversity (scope advantages), integrating specialist assets and expertise in response to their changing competitive environments. Nohria and Ghoshal also call this ideal organisational form the 'differentiated network', building on previous studies of multinational networks.[32]

✔ Active learning check

Review your answer to Active Learning Case question 3 and make any changes you like. Then compare your answer to the one below.

3 **What indications are there that the Mac 400 ECG has become an example of 'local-for-global' innovation?**

Innovation conducted at the local level, by the Indian R&D division, is already providing an input into designing and developing products to sell abroad. The Mac 400 ECG has had some success selling in countries outside India. Specifically, it provides a cheaper, simpler alternative for customers in low-income countries that are similar to India. So while the Indian R&D division was established to serve the Indian market, the locally appropriate, frugal innovation outputs it produces match the needs of other, similar markets.

INTERNATIONAL BUSINESS STRATEGY IN ACTION

Innovation networks at IBM

Between the summer of 2010 and early 2011, an IBM computer named ‘Watson’ challenged and eventually beat other (human) contestants on the US game-show *Jeopardy!* It was seen to be a step-change in computing intelligence and a demonstration of the excellence of IBM’s global R&D network. The computer, named after two of the firm’s original founders, Thomas J. Watson Sr. and his son Thomas J. Watson Jr., can understand natural language and find answers to real questions across a wide range of subject areas. Built by linking 90 servers using IBM’s ‘DeepQA architecture’, it is the result of years of work by the company’s leading researchers and is now being deployed as a support tool in healthcare, finance and customer services.

IBM has long been a dominant global force in science and technology development. In 2016 the firm generated an average of over 22 patents per day, with a total figure greater than 8,0000 US patents for the single year. IBM has continually positioned itself at the top of the patent list for 25 years and between 1993 and 2017 it received over 105,940 US patents (see Table 3.4). The firm invests around $6 billion in R&D annually, resulting in intellectual property (IP) income of about $1 billion each year as well as a stream of new technologies, products and services. Ginni Rometty, IBM’s chairman, president and CEO stated that ‘IBM’s continued investment in research and development is key to driving the transformation of our company, as we look to capture the emerging opportunities represented by cloud bug data analytics, security, social, and mobile.’

In 2008 the incoming director of R&D at IBM, John Kelly, embarked on a restructuring programme in response to both the development of new R&D competitors, such as Microsoft, Google and Amazon, and new opportunities in emerging economies. This took the lead from CEO Sam Palmisano, who had a clear view of what a ‘globally integrated enterprise’ should look and act like: ‘a new kind of enterprise which is best understood as global rather than multinational.’ Kelly visited the eight IBM research labs around the world, including China, India and Israel, to gain insights from the firm’s global workforce of 3,200 researchers. On the basis of this, he decided to further internationalise the company’s R&D structure and consolidate the fragmented allocation of resources into larger-scale, leading projects.

Table 3.4 Top ten patent recipients, 2017

Rank	Organisation	No. of patents
1	IBM	9,043
2	Samsung	5,837
3	Canon	3,285
4	Intel	3,023
5	LG Electronics	2,701
6	Qualcomm	2,628
7	Google Inc.	2,457
8	Microsoft	2,441
9	Taiwan Semiconductor Manufacturing	2,425
10	Samsung Display	2,273

Source: 2017 Top 25 USPTO Recipients, United States Patent Office.

Both of these strategies have been seen by insiders as signalling a shift from the traditional US-based R&D centres to new initiatives in emerging economies. In 2010 the firm added R&D labs in Brazil and Ireland which looked into smarter natural resource management and innovations for societal and infrastructure transformations respectively. In 2011 IBM opened a R&D lab in Australia with a focus on smarter natural resource management related to resource discovery. In 2013 the company further expanded its worldwide portfolio of science and technology expertise by opening an R&D centre in Nairobi, Kenya (see Table 3.5). As of 2016, IBM has created a global network of 3,000 researchers across 12 labs in six continents.

Global alliances and collaboration are also a central part of the strategy. Kelly uses the term *collaboratories* to denote 'agile, in-market research' activities which connect with universities and science and technology institutes in different countries, rather than investing in large-scale, brick-and-mortar laboratories. Significantly, this also means conducting research closest to the problem. For example, instead of tackling transportation issues in the United States, where the infrastructure is in line with growth, he suggests that IBM will focus on a country, city and area where road traffic is a primary problem, such as Mumbai.

IBM has developed a number of unique networking mechanisms for connecting researchers and employees for innovation. It holds a 'smart camp' and uses Facebook to host discussions between

its in-house researchers and other experts around the world. ‘Jams’ or ‘jamming’ are another unusual way the firm promotes technology-based creativity. These are online brainstorming sessions for huge numbers of people to share ideas and discuss key challenges which can be commercial or related to social or environmental issues. In 2006 the ‘Innovation Jam’ connected over 150,000 people from 104 countries and 67 companies. Ten new IBM businesses were launched as a result, with seed investment totalling $100 million. An Innovation Jam in 2008 demonstrated how powerful ‘crowd sourcing’ for new ideas could be. Since then IBM has coordinated online jams on governance, technology and security. In 2011 the Prince of Wales in the UK kicked off ‘Start Jam’, focusing on sustainable business practices.

Table 3.5 IBM’s research labs

Where?	Established when?	Doing what?
Almaden, San Jose, CA, USA	1955	Computer science, database, user interface, web software, storage systems software and technology, physical sciences, materials science, nanotechnology, life sciences and services research
Zürich, Rüschlikon, Switzerland	1956	Nanoscience and technology, semiconductor technology, storage systems, advanced server technology, systems design, IT security and privacy, business optimisation, mobile enablement, services research and industry solutions lab
Watson, NY and MA, USA	1961	Computer science, database, data mining, business intelligence, user interface, storage systems software, materials science, nanotechnology, life sciences, services research, mathematics and semiconductor technology
Haifa, Israel	1972	Storage and business continuity systems, verification technologies, multimedia, active management, information retrieval, programming environments, optimisation technologies and life sciences
Tokyo, Yamato, Japan	1982	Analytics and optimisation, software engineering, middleware, system software, security and compliance, electronical and optical packaging technology, engineering and technology services, text mining and speech technology and accessibility centre
Beijing, China	1995	Business integration and transformation, information and knowledge management, future embedded systems and devices, resilient and pervasive infrastructure and user interactions

Austin, TX, USA	1995	High-performance/low-power VLSI design and tools, system-level power analysis and new system architectures
Delhi and Bangalore, India	1998	Speech technologies, pervasive computing, e-governance, information management, e-commerce, life sciences, distributed computing and software engineering
São Paulo and Rio de Janeiro, Brazil	2010	Smarter natural resource management, smarter devices, smarter human systems, service systems and underlying technologies including analytics and optimisation, distributed systems, mobile technologies, semiconductor packaging and high-performance computing
Dublin, Ireland	2010	Innovations for societal and infrastructure transformations, with a focus on improving city operations and the well-being of citizens
Melbourne, Australia	2011	Smarter natural resource management related to resource discovery, production, supply chain and operations. Smarter natural disaster management including real-time event (stream) processing, weather modelling, traffic management and mobility analytics
Nairobi, Kenya	2013	Developing commercially viable solutions to transform lives and spark new business opportunities in key areas such as water, agriculture, transportation, healthcare, financial inclusion, education, energy, security and e-government
Johannesburg, South Africa	2016	Exploring the use of cognitive computing, the internet of things and big data in order to support South Africa's national needs and priorities, as well as to drive skills development and foster innovation and economic growth

Source: Adapted from http://www.research.ibm.com/worldwide/index.shtml.

Some of IBM's global networking efforts are clearly, at least in part, public relations exercises. But it has obviously developed a sophisticated range of networks and organisation mechanisms to connect and leverage the huge range of in-house R&D expertise it has invested in and simultaneously tap into external sources of knowledge and capabilities for innovation. Increasing the number of patents by 40 per cent within the last five years leaves no doubt that IBM is a leader in R&D which covers a range of areas including cloud computing, analytics, mobile, social media and security-related platforms.

Source: 'Setting IBM's R&D Agenda', Business Week, April 2008; a video of John Kelly, Director of Research at IBM, is available at: http://www.businessweek.com/innovate/content/apr2008/id20080416_955900.htm; Samuel J. Palmisano, 'The globally integrated enterprise', Foreign Affairs, May/June 2006; https://www.research.ibm.com/labs/; http://www.facebook.com/ibmwatson; http://www.ibm.com/developerworks/community; http://www.research.ibm.com/worldwide/index.shtml; http://www.youtube.com/watch?v=cU-AhmQ363I&feature=relmfu; http://www-03.ibm.com/press/us/en/pressrelease/32757.wss; https://www.collaborationjam.com; https://www-03.ibm.com/press/us/en/pressrelease/45793.wss.

The innovative MNE as a differentiated network

MNEs, large and small, have to both adapt to local conditions and optimise their scale and scope advantages by standardising products, services, brands and organisational practices as much as possible. Hence, they face the dilemma of having to be both 'global' and 'local' at the same time. But one of the major natural competitive advantages of MNEs results from their ability to combine (and continually recombine) various inputs (particularly knowledge and expertise) into the innovation process, from different locations, to serve different customer needs across a variety of markets. Their ability to exploit this advantage depends to a significant degree on how they are structured to manage networks which connect these locations and incentivise specialists to connect across these networks to add value.[33]

Differentiated networks require strong integrative and dynamic capabilities to operate effectively. Not only must they integrate disparate resources and knowledge from the various parts of the firm, but they must also continually develop and recombine these assets in response to the complex and changing range of external innovation opportunities. In theory this is straightforward, but in practice there are many organisational barriers

and constraints to resource and knowledge sharing. Moreover, which opportunities should be targeted and which areas of resource allocation or knowledge development should be prioritised is continually contested.

Firms that do develop more effective ways of integrating specialist knowledge for innovation tend to have a degree of 'slack' in their configuration of assets, resources and expertise. Clayton Christensen notes this in his analysis of how firms become locked into certain sets of markets, resources and capabilities by focusing on cost cutting and efficiency. Over time they lose the flexibility to explore, experiment and innovate their way on to a new 'S-curve'.[34] Firms that operate as dynamic networks also balance the division of decision-making responsibility for innovation between headquarters (the centre) and subsidiaries (the periphery), and develop organisational mechanisms, such as project structures, incentives, communication channels, IT systems, roles and responsibilities for connecting specialist sources of knowledge around the firm and leveraging these to serve clients and customers.

Research has shown how and why firms differ in their 'integrative' innovation capabilities. Sony, for example, in comparison with counterparts like Panasonic (formerly known as Matsushita) and Philips, has a strong set of organisation coordination mechanisms, communication practices and employee incentives for connecting market opportunities with technological potential in its consumer electronics division.[35] This involves combining software and hardware specialists to create new functionalities in multimedia products and linking them effectively with consumers to develop some expertise in what drives patterns of adoption and use. Rather than relying on the marketing function to produce data and analysis on customers, Sony tends to encourage engineers and technologists to observe or work with customers directly to understand what kinds of innovation add value for them.

Compared to other Japanese firms, Sony is fairly unusual in its so-called **ambidexterity**: that is, its ability 'to be aligned and efficient in its management of today's business demands while simultaneously being adaptive to changes in the environment'.[36] Sony is continually coming up with new technology platforms (CDs, DVDs, minidisks, and so on) and new products based around these platforms. But it also invests in improving current product lines, with new models and new features, and it strives to make them cheaper through economies of scale and continuous improvement in manufacturing. Many Japanese firms are renowned for their incremental process and product innovation capabilities, but are weaker in terms of their radical or R&D-driven innovation. Moreover, they tend to be more locked into domestic market R&D and innovation networks, compared to counterparts from the United States or Europe.[37]

The original studies leading to the concept of the differentiated network focused predominantly on manufacturing firms, but as innovation in multinational networks has become more widely analysed, knowledge-based services and other business sectors have also been examined.[38]

KEY POINTS

1. The VRIO framework, a theoretical model built upon RBV, helps us to assess and understand the FSAs that will lead to competitive advantages. For the firm to have competitive advantages, they must fulfil four criteria: the FSAs must be valuable (V), rare (R), imperfectly imitable (I) and properly organised (O).
2. Dynamic capability is the firm's ability to integrate, build and reconfigure internal and external competences to address rapidly changing environments. The dynamic capabilities approach is useful to understand how successful firms are able to stay competitive in changing environments. If a firm fails to adapt to changing pressures and opportunities, or does not have the capabilities to do so, then it will lose its competitiveness and risk failing.
3. The quality of local scientific, technological, design-related and creative expertise, combined with institutional relationships between enterprises, universities and government research organisations, underpins the competitiveness of a region and is key in driving innovation. These are one form of country-specific advantage (CSAs) that supports the development of firm-specific advantages (FSAs). Firms that evolve in regions with high-quality capabilities and institutions benefit from this by gaining competitive advantages that help them expand internationally. These location endowments also make such locations attractive to other firms engaged in FDI.
4. Firms centralise or de-centralise various innovation activities (sensing, responding to and implementing) globally depending on the trade-offs

between standardisation and economies of scale and the need for national responsiveness. The centre-for-global, local-for-local, local-for-global and global-for-global typology and the concept of differentiated networks for innovation capture this key trade-off.

Key terms

- **innovation**
- **KTI industries**
- **dynamic capability**
- **systems of innovation (SI)**
- **centre-for-global, local-for-local, local-for-global and global-for-global**
- **ambidexterity**

REAL CASE

Canon Group

Few companies can claim to be truly global multinationals, but with sales, revenues, production and employees distributed across the world, the Canon Group of Japan comes as close as any to fitting that title. In 2010, Canon's sales grew 23 per cent compared to the previous year, to a record high of US$42.225 billion. The company then seemed to struggle. By 2015 its revenues had dropped to US$31.54 billion and they only slightly increased again by 2018, when revenues were US$36.7 billion. These figures are partly the result of the declining popularity of cameras, as customers increasingly used their smartphones for taking pictures. Nevertheless, the firm's sales are spread evenly across the world's main markets, with over 80 per cent of its products sold outside Japan. In 2017, 27 per cent of its net sales were in the Americas, 25 per cent in Europe and 26 per cent in Asia and Oceania.

As of 2017, Canon operates in four business segments. The Office segment provides office network, colour network and personal multifunction devices, office, colour and personal copy machines, laser printers, large-sized ink-jet printers and digital production printers, among others. With a sales ratio of 45.7 per cent as of 2017, this business segment is Canon's major source of income. The Imaging System segment provides digital single-lens reflex cameras, compact digital cameras, interchangeable lens, digital video cameras, ink-jet multifunction devices, single-function ink-jet printers, image scanners and television lenses for broadcasting use, among others. The Industrial Equipment segment and the Medical System segment provide exposure equipment used in semiconductor and liquid crystal displays (LCDs), medical image-recording equipment, ophthalmic instruments, magnetic heads, micro motors, computers, handy terminals, document scanners and calculators, among others. Canon is dual listed on the Tokyo Stock Exchange and New York Stock Exchange.

The company had its beginnings in 1933, when Precision Optical Instruments Laboratory was established to conduct research into cameras in Roppongi, Minato-ku, Tokyo. In 1947 the company changed its name to Canon Camera Co., and only in 1969 did the company take on the name Canon Inc.

Canon's international expansion started in 1955 with the opening of a New York branch. Initially, the company relied on sole distributors and established some in Europe and Latin America in the late 1950s and early 1960s. The sole distributor system was abolished in 1963 to make way for company-owned subsidiaries under the direct control of the Japanese headquarters.

International expansion goes beyond marketing to include production, research and development. Taiwan became the site of Canon's first foreign production facility in 1970. Two years later the company opened a manufacturing plant in Germany. By 2001, the company had production facilities in all parts of the triad – Western Europe, the Asia–Pacific region and North America. Nevertheless, the vast majority of Canon's production facilities remain in Asia, including Japan. So in contrast to the global distribution of its sales, 37 per cent of its employees (73,665 in 2017) were based in Japan and just 12 per cent in Europe, 9 per cent in North America, and 40 per cent elsewhere, predominantly in Southeast Asian production centres.

From 1990 onwards, R&D centres were opened in the United States, Australia, France, Thailand and the People's Republic of China. Each R&D facility specialises in a specific product line and is coordinated by a centralised R&D lab in Japan. Together with its R&D strategy, this has made Canon one of the best world innovators and the largest holder of patents after IBM and Samsung.

Canon is organised regionally. Canon USA oversees operations in the Americas. The subsidiary has its own marketing, R&D and production facilities. Two companies oversee European operations. Together, they have two manufacturing plants in Germany and France, and R&D centres in the UK and France. Canon's operations in Asia and Oceania, excluding Japan, account for the largest number of employees in foreign countries. Region-wide activities for the Asian market are overseen by the Canon Asia Marketing Group, but marketing operations in this region are fragmented into sub-regional or national markets. The Southeast Asia region is the responsibility of Canon Singapore. Hong Kong has its own subsidiary that is also responsible for Taiwan and part of South Korea. The mainland Chinese market is the responsibility of Canon (China) Co. Japan's home market is still very important. Nearly half of Canon's employees are still working in Japan and company-wide R&D is still centralised there. Canon Australia is responsible for operations in the Oceania region.

In 2017, the firm spent 8.1 per cent of its revenue on R&D. Canon finds not only new technologies, but also new methods of manufacturing products. Canon has been reorganising its production facilities to take advantage of its global scope, selecting suppliers and production facilities across the world to minimise costs and decrease production time. As a result, product design data can now be sent to plants around the world via computer. Information is translated through an automatic translation system allowing faster communication between subsidiaries. The firm is now using simulation technology to minimise the costly process of prototype production.

At a time when other Japanese and many other, large electronic companies are struggling to remain competitive, Canon's profits are soaring. The firm has been able to remain competitive by selecting those business lines in which it can be successful, given its strength in R&D and production technology. The firm abandoned the markets for personal computers, typewriters and liquid crystal displays to concentrate on cameras, printers and copiers.

Studies suggest that one of Canon's key competencies is its global system for new product development. In particular, it has evolved a number of organisational mechanisms for linking R&D and customer requirements globally. This is partly done through alliances and joint ventures in which Canon invests over the long term to derive the benefits of co-learning and joint resource development. Canon contributes its technological capabilities and supplier links, and local partners bring expertise relating to local customer preferences, distribution and marketing.

On the plant floor, Canon's high productivity increases have been based on cell production technology. Here, a small number of workers have responsibility for the final assembly of the product. This type of production not only increases the amount of a product being produced per labour-hour, but also ensures quality as it is easier to backtrack the production process of a single product. It also saves floor space. Since 1998, Canon has decreased the length of its conveyor lines by 12 miles (19 km). However, the productivity increases of applying and perfecting cell technology to its operations are reaching a limit and now Canon is seeking ways of integrating automation technology into its production process.

In 2002, Canon made the unlikely decision to establish a facility in Oita, Kyushu, Japan, to produce digital cameras. CEO Fujio Mitarai's explanation is that 'If we switch factories each time a place with lower labour costs is found, all investment in equipment is wasted. Instead, we should

use our strengths in production, and manufacture products more cheaply than they could be manufactured in locations where the cost of labour is lower.' As of 2017, approximately 65 per cent of Canon cameras were manufactured in Japan. This number is expected to grow in the next years, as the company plans to return to a 'Made in Japan' strategy, where automation and robots will do most of the work in the Japanese plants. Nevertheless, the company's long-term plan is to reach a balance between outsourcing and Japanese production. Mitarai's position is that anything for which labour costs are more than 5 per cent of production costs can be outsourced to low labour-cost areas, such as China, and anything for which labour costs are less than 5 per cent of production – typically the more advanced technologies – can be produced domestically.

Website: www.canon.com.

Source: Canon, http://www.canon.com/ir/finance/highlight.html (accessed 2016); Canon, *Annual Repor*t, 2006–2017; 'Can Canon keep printing money?', *Business Week*, 5 September 2005; 'Hard to copy', *The Economist*, 31 October 2002; '(Still) made in Japan', *The Economist*, 7 April 2004; B. Bowonder and T. Miyake, 'R&D and business strategy: analysis of practice at Canon', *International Journal of Technology Management*, vol. 13, nos. 7/8 (1997), pp. 833–53; H. Perks, 'Exploring processes of resource exchange and co-creation in strategic partnering for new product development', *International Journal of Innovation Management*, vol. 8, no. 1 (2004), pp. 37–61; Thomson Reuters, *OneSource,* 2011. https://asia.nikkei.com/Business/Canon-back-to-Made-in-Japan.

1 Explain why, over the course of Canon's internationalisation process, certain functions have been moved or expanded to certain global locations.

2 Why has it been important for Canon to internationalise its R&D activities?

3 Speculate as to why Canon is so unusual in its degree of independence from Japan's domestic market, compared to most other Japanese firms.

4 How is Canon still fairly dependent on Japan as a home base?

REAL CASE

R&D at Hewlett-Packard

Founded in a small garage by William Redington Hewlett and David Packard in 1939, The Hewlett-Packard Company (HP) is a multinational American organisation that develops a range of computer hardware components. HP also provides software and IT-related services to SMEs and large organisations and is headquartered in Palo Alto, California, US. In 2014, HP split into two separate entities, with one being Hewlett-Packard Enterprise, which sells servers and enterprise services, and the other one being HP Inc which focuses on PCs and printers. The deal was motivated by the opportunity to save around $1 billion in operating costs.

Before the split, HP primarily had seven basic R&D centres: in Palo Alto, California; Cambridge, Massachusetts; Bristol, England; Galway, Ireland; Grenoble, France; Haifa, Israel; and Tokyo, Japan. These explored a wide range of technologies more or less linked to its product range. Its Advanced Studies Research Labs include a sub-group doing information theory research, linking the Mathematical Science Group based in Bristol with experts at the US universities at Stanford and Berkeley. Grenoble specialises in business PC design and development and Israel in image and document processing, among other areas.

These centres of research excellence were linked to HP's global product divisions, mainly headquartered in the United States, and its national subsidiaries around the world, which encompass most of its 85,500 employees.

The Palo Alto centre pioneered HP's thermal ink-jet technology, for example. Its Consumer Products group, headquartered in San Diego, California, designed, developed and led the manufacturing of a range of imaging products using this technology. The firm's subsidiary in Singapore customises the design and produces thermal ink-jet printers for the Japanese and Asian markets.

The R&D structure of the firm evolved a step further when the Singaporean subsidiary took the lead from San Diego for the design, development and manufacturing of a new range of portable ink-jet printers. It had built up a range of specialist capabilities, through learning from other parts

of the internal network and through local Asian technical partnerships and subcontractors, which made it the best place to lead innovation efforts in this area for the firm as a whole.

HP has developed a strong culture of creative innovation, going back to its roots as a garage-based start-up. In addition to the ‘formal’ R&D function, with its global network of R&D centres, HP promotes innovation across all of its functions and employees. Continuous improvement of technologies, products, services and solutions which exploit new technological trends and match these to the changing needs of customers is encouraged across the firm. HP focuses its efforts on areas where it believes it can make a unique contribution, which at times also include forming partnerships with other leading organisations.

In 2015 HP invested US$3.5 billion into R&D, up from US$3.45 billion in 2014 and US$3.14 billion in 2013. But the firm’s R&D investment as a percentage of sales (a standard measure of R&D ‘intensity’) declined from 3.9 per cent in 2006 to less than 3 per cent in 2015.

With the help of its R&D centres, HP has recently been able to develop new products and services around the cloud storage platform and related to ‘big data’. In 2015, HP opened an 87,000 ft^2 Innovation Center in Ballybrit, Galway, Ireland, with a workforce of 700 engineers, consultants and support team. With the opening of this new Innovation Center, HP is striving to become a leader in software R&D, cloud technology and service innovation. Similarly, the 2017 opening of its new research centre in Singapore is aimed at allowing engineers to experiment, design and find solutions for improving the company’s manufacturing processes.

Conclusion

Even though HP’s expenditure on R&D has been increasing, it is still relatively low compared to some of its competitors and particularly low as a percentage of sales. For example, Microsoft spends approximately 15 per cent of its revenues on R&D, IBM 5–7 per cent, and SAP 14 per cent. However, in consecutive annual reports, HP states its intention to invest larger sums into R&D. The central belief of HP’s founders, David Packard and William Hewlett, from the days of the garage in Palo Alto, that investing in R&D to drive continuous innovation is necessary for long-term competitive advantage, still runs strong.

Website: https://www.hpe.com/uk/en/home.html

Source: HP, *Annual Report*, 2014; Cliff Saran, 'HP CEO Meg Whitman pushes hardware R&D strategy', *Computer Weekly*, 10 May 2012; 'HP opens new Innovation Facility in Galway', ARUP, 13 May 2015, arup.com; 'Invest in the West – MJ Conroy & HP Ballybrit', *Irish Building*, 9 February 2015. https://www.businesstimes.com.sg/technology/hp-unveils-s100m-campus-home-to-its-first-advanced-manufacturing-centre.

1 Discuss if HP has competitive advantages and if there are examples of dynamic capabilities.

2 Discuss the interaction of CSAs and HP's FSAs in developing its competitive advantages.

3 Discuss whether the Singapore R&D subsidiary is: centre-for-global, local-for-local, local-for-global or global-for-global.

NOTES

1 Although slightly dated, this definition is still one of the best. European Commission, "Green Paper on Innovation," *Bulletin of the European Union, Supplement 5/95* (Brussels: European Commission, 1995, p. 1).

2 National Science Board, *Science and Engineering Indicators 2018* (Arlington, VA: National Science Foundation) (NSB 14-01). Chapter 6 'Industry, Technology, and the Global Marketplace'.

3 Ibid.

4 National Science Board, *Science and Engineering Indicators 2018*.

5 For a review on innovation management measures, see: Adams, R., Bessant, J. and Phelps, R., 'Innovation management measurement: A review', *International Journal of Management Reviews*, vol. 8, no. 1 (2006), pp. 21–47.

6 http://www.theguardian.com/society/2015/jul/24/first-malaria-vaccine-given-green-light-by-european-regulators

7 E. T. Penrose, *The Theory of the Growth of the Firm* (New York: John Wiley, 1959); B. Wernerfelt, 'A resource-based view of the firm', *Strategic Management Journal*, vol. 5, no. 2 (1984), pp. 171–80.

8 J. Bell, D. Crick and S. Young, 'A holistic perspective on small firm growth and internationalisation', *Academy of International Business Conference*, City University Business School (1998).

9 E. Beleska-Spasova, K. W. Glaister and C. Stride, 'Resource determinants of strategy and performance: the case of British exporters', *Journal of World Business*, vol. 47, no. 4 (2012), pp. 635–47.

10 R. Amit and P. J. H. Schoemaker, ‘Strategic assets and organizational rent’, *Strategic Management Journal*, vol. 14, no. 1 (1993), pp. 33–46; J. Barney, ‘Firm resources and sustained competitive advantage’, *Journal of Management*, vol. 17, no. 1 (1991), pp. 99–120.

11 R. Makadok, ‘Toward a synthesis of the resource-based view and dynamic-capability views of rent creation’, *Strategic Management Journal*, vol. 22, no. 5 (2001), pp. 387–401.

12 J. Barney, ‘Firm resources and sustained competitive advantage’, *Journal of Management*, vol. 17, no. 1 (1991), pp. 99–120.

13 J. B. Barney, ‘Looking inside for competitive advantage’, *Academy of Management Executive*, vol. 9, no. 4 (1995), pp. 49–61.

14 Ibid.

15 R. Narula, ‘Do we need different frameworks to explain infant MNEs from developing countries?’, *Global Strategy Journal*, vol. 2, no. 1 (2012), pp. 41–7.

16 J. B. Barney, ‘Looking inside for competitive advantage’, *Academy of Management Executive*, vol. 9, no. 4 (1995), pp. 49–61.

17 Ibid.

18 Campbell, P. and Waters, R. (2018) ‘Tesla seeks to convince it has turned the corner.’ *Financial Times*, 2 August. Available at: https://www.ft.com/content/ea70d7f8-9644-11e8-b747-fb1e803ee64e (last accessed: 27 November 2018).

19 Martin, Andrew. ‘Kodak to sell patents for $525 Million’, *The New York Times*, (December 2012).

20 D. J. Teece, ‘The Foundations of Enterprise Performance: Dynamic and Ordinary Capabilities in an (economic) Theory of Firms’, *Academy of Management Perspectives*, vol. 28, no. 4 (2014), pp. 328–52; S. G. Winter, ‘Understanding dynamic capabilities’, *Strategic Management Journal*, vol. 24, no. 10 (2003), pp. 991–5.

21 D. J. Teece, ‘A dynamic capabilities-based entrepreneurial theory of the multinational enterprise’, *Journal of International Business Studies*, vol. 45, no. 1 (2014), pp. 8–37.

22 B., Grogaard, A. Verbeke and M. A. Zargarzadeh. ‘Chapter 6 Entrepreneurial Deficits in the Global Firm.’ In *Entrepreneurship in the Global Firm*, pp. 117–37. Emerald Group Publishing Limited (2011); R. Narula and A. Verbeke, ‘Making internalization theory good for practice: The essence of Alan Rugman’s contributions to international business’, *Journal of World Business*, vol. 50, no. 4 (2015), pp. 612–22; C. N. Pitelis and D. J. Teece. ‘Cross-border market co-creation, dynamic capabilities and the entrepreneurial theory of the multinational enterprise’, *Industrial and Corporate Change*, vol. 19, no. 4 (2010), pp. 1247–70.

23 J. Rice, T. S. Liao, P. Galvin and N. Martin, ‘A configuration-based approach to integrating dynamic capabilities and market transformation in small and medium-sized enterprises to achieve firm performance’, *International Small Business Journal*, vol. 33, no. 3 (2015), pp. 231–53.

24 C. E. Helfat et al., *Dynamic Capabilities: Understanding Strategic Change in Organisations* (Malden, MA: Blackwell, 2007) is the best overview of the dynamic capabilities field, from a theory perspective. A good set of papers also appears in: M. Easterby-Smith, M. A. Lyles and M. A. Peteraf, ‘Dynamic capabilities: current debates and future directions’, *British Journal of Management*, vol. 20, no. 1 (2009), pp. S1–S8. Some studies explicitly focus on dynamic capabilities in small firms, such as: E. Døving and P. Gooderham, ‘Dynamic capabilities as antecedents of the scope of related diversification: the case of small firm accountancy practices’, *Strategic Management Journal*, vol. 29, no. 8 (2008), pp. 841–57.

25 Research on capability life cycles, such as: C. E. Helfat and M. A. Peteraf, 'The dynamic resource-based view: capability lifecycles', *Strategic Management Journal*, vol. 24 (2003), pp. 997–1010, has obvious parallels with research on S-curves. S-curves show how firms can become over-dependent on and 'locked' into an over-reliance on certain kinds of products, assets, and capabilities, such that when markets or technologies change they are unable to reinvent themselves and go into decline. See, among other work: C. Christensen, *The Innovator's Dilemma* (Boston, MA: Harvard Business School Press, 1997).

26 J. A. Schumpeter, *Capitalism, Socialism and Democracy* (New York: Harper, 1942).

27 C. Freeman, 'The national system of innovation in historical perspective', *Cambridge Journal of Economics*, no. 19 (1995), pp. 5–24; B.-A. Lundvall, *National Systems of Innovation: Toward a Theory of Innovation and Interactive Learning* (London: Anthem Press, 2010); R. Nelson (ed.), *National Innovation Systems: A Comparative Analysis* (Oxford: Oxford University Press, 1993).

28 C. Edquist and B. Johnson, 'Institutions and organizations in systems of innovation', in C. Edquist (ed.), *Systems of Innovation: Technologies, Institutions and Organizations* (London: Pinter Publishers/Cassel Academic, 1997, p. 46).

29 R. Narula, *Gobalization and Technology* (London: Polity Press, 2003).

30 C. Bartlett and S. Ghoshal, *Managing across Borders: The Transnational Solution* (Boston, MA: Harvard Business School Press, 2002).

31 N. Nohria and S. Ghoshal, *The Differentiated Network: Organizing MNCs for Value Creation* (San Francisco, CA: Jossey-Bass, 1997).

32 In addition to Nohria and Ghoshal (1997, op. cit.), a range of related readings on this topic can be found in C. Bartlett, S. Ghoshal and J. Birkinshaw, *Transnational Management: Text, Cases, and Readings in Cross-Border Management* (London: McGraw-Hill, 2004).

33 M. Adenfelt and K. Lagerström, 'The development and sharing of knowledge by centres of excellence and transnational teams: a conceptual framework', *Management International Review*, vol. 48, no. 3 (2008), pp. 319–38.

34 C. M. Christensen, *The Innovator's Dilemma: When New Technologies Cause Great Firms to Fail* (Boston, MA: Harvard Business School Press, 1997).

35 S. C. Collinson, 'Organising for multimedia product development: Sony and Philips compared', *Communications and Strategies*, vol. 19 (1995), pp. 47–77.

36 S. Raisch and J. M. Birkinshaw, 'Organizational ambidexterity: antecedents, outcomes, and moderators', *Journal of Management*, vol. 34, no. 3 (2008), pp. 375–409.

37 S. C. Collinson and A. M. Rugman, 'The regional nature of Japanese multinational business', *Journal of International Business Studies*, vol. 39, no. 2 (2008), pp. 215–30; S. C. Collinson and D. C. Wilson, 'Inertia in Japanese organizations: knowledge management routines and failure to innovate', *Organization Studies*, vol. 27, no. 9 (2005), pp. 1359–87.

38 See, for example, M. L. Mors, 'Innovation in a global consulting firm: when the problem is too much diversity', *Strategic Management Journal*, vol. 31, no. 8 (2010), pp. 841–87.

BIBLIOGRAPHY

Bessant, John and Tidd, Joe. *Innovation and Entrepreneurship* (London: John Wiley & Sons, 2nd ed., 2011).

Beugelsdijk, Sjoerd, Hennart, Jean-François, Slangen, Arjen and Smeets, Roger. ‘Why and how FDI stocks are a biased measure of MNE affiliate activity’, *Journal of International Business Studies*, vol. 41, no. 9 (2010).

Blundel, Richard and Lockett, Nigel. *Exploring Entrepreneurship: Practices and Perspectives* (Oxford: Oxford University Press, 2011).

Buckley, Peter J. and Strange, Roger. ‘The governance of the multinational enterprise: insights from internalization theory’, *Journal of Management Studies*, vol. 48, no. 2 (2011).

Chesbrough, Henry, Vanhaverbeke, Wim and West, Joel. *Open Innovation: Researching a New Paradigm* (Oxford: Oxford University Press, 2008).

Crossan, Mary M. and Apaydin, Marina. ‘A multi-dimensional framework of organizational innovation: A systematic review of the literature’, *Journal of Management Studies,* vol. 47, no. 6 (2010).

Datta, Deepak K., Liang, Xin and Musteen, Martina. ‘Strategic orientation and the choice of foreign market entry mode’, *Management International Review*, vol. 49, no. 3 (2009).

Golovko, Elena and Valentini, Giovanni. ‘Exploring the complementarity between innovation and export for SMEs’ growth’, *Journal of International Business Studies*, vol. 42, no. 3 (2011).

Gronum, Sarel, Verreynne, Martie-Louise and Kastelle, Tim. ‘The role of networks in small and medium-sized enterprise innovation and firm

performance', *Journal of Small Business Management*, vol. 50, no. 2 (2012).

Helms, Marilyn M. and Nixon, Judy. 'Exploring SWOT analysis – where are we now? A review of academic research from the last decade', *Journal of Strategy and Management*, vol. 3, no. 3 (2010).

Hennart, Jean-François. 'Down with MNE-centric theories! Market entry and expansion as the bundling of MNE and local assets', *Journal of International Business Studies*, vol. 40 (August 2009).

Hovhannisyan, Nune and Keller, Wolfgang. 'International business travel: an engine of innovation?', *Journal of Economic Growth*, vol. 20, no. 1 (2015), pp. 75–104.

Hutzschenreuter, Thomas, Voll, Johannes C. and Verbeke, Alain. 'The impact of added cultural distance and cultural diversity on international expansion patterns: a Penrosean perspective', *Journal of Management Studies*, vol. 48, no. 2 (March 2011).

Javalgi, Rajshekhar (Raj) G., Deligonul, Seyda, Ghosh, Amit K., Lambert, Douglas M. and Cavusgil, S. Tamer. 'Foreign market entry mode behavior as a gateway to further entries: the NAFTA experience', *International Business Review*, vol. 19, no. 3 (June 2010).

Kyläheiko, Kalevi, Jantunen, Ari, Puumalainen, Kaisu, Saarenketo, Sami and Tuppura, Anni. 'Innovation and internationalization as growth strategies: the role of technological capabilities and appropriability', *International Business Review*, vol. 20, no. 5 (2011).

Lambert, Susan C. and Davidson, Robyn A. 'Applications of the business model in studies of enterprise success, innovation and classification: an analysis of empirical research from 1996 to 2010', *European Management Journal*, vol. 31, no. 6 (2013).

Makino, Shige and Tsang, Eric W. K. 'Historical ties and foreign direct investment', *Journal of International Business Studies*, vol. 42 (2010).

Morschett, Dirk, Schramm-Klein, Hanna and Swoboda, Bernhard. 'Entry modes for manufacturers' international after-sales service: analysis of transaction-specific, firm-specific and country-specific determinants', *Management International Review*, vol. 48, no. 5 (2008).

Mudambi, Ram and Swift, Tim. 'Leveraging knowledge and competencies across space: the next frontier in international business', *Journal of International Management*, vol. 17, no. 3 (2011).

Mudambi, Ram, Narula, Rajneesh and Santangelo, Grazia D. 'Location, collocation and innovation by multinational enterprises: a research agenda' *Industry and Innovation*, vol. 25, no. 3 (2018), pp. 229–41.

Nguyen, Quyen T. K. 'The empirical literature on multinational enterprises, subsidiaries and performance', *Multinational Business Review*, vol. 19, no. 1 (2011).

Nieto, María Jesús and Rodríguez, Alicia. 'Offshoring of R&D: looking abroad to improve innovation performance', *Journal of International Business Studies*, vol. 42, no. 3 (2011).

Prabhu, J. and Radjou, N. *Frugal Innovation: How to Do More with Less* (London: Economist Books, 2015).

Prahalad, C. K. and Krishnan, M. S. *The New Age of Innovation: Driving Co-created Value through Global Networks* (New York: McGraw-Hill Professional, 2008).

Soete, Luc, Verspagen, Bart and Ter Weel, Bas. 'Systems of innovation'. In *Handbook of the Economics of Innovation*, vol. 2, (2010), pp. 1159–80, North-Holland.

Teece, D. J. 'A dynamic capabilities-based entrepreneurial theory of the multinational enterprise', *Journal of International Business Studies*, vol. 45, no. 1 (2014), pp. 8–37.

Teece, D. J. 'Explicating dynamic capabilities: The nature and microfoundations of (sustainable) enterprise performance', *Strategic*

Management Journal, vol. 28, no. 13 (2007), pp. 1319–50.

Teece, D. J. *Dynamic Capabilities and Strategic Management: Organizing for Innovation and Growth* (Oxford University Press on Demand, 2009).

Tidd, Joe and Bessant, John. *Managing Innovation: Integrating Technological, Market and Organizational Change* (London: John Wiley & Sons, 2009).

Zahra, S. A., Sapienza, H. J. and Davidsson, P. 'Entrepreneurship and dynamic capabilities: a review, model and research agenda', *Journal of Management Studies*, vol. 43, no. 4 (2006), pp. 917–55.

Zollo, M., Bettinazzi, E. L., Neumann, K. and Snoeren, P. 'Toward a comprehensive model of organizational evolution: Dynamic capabilities for innovation and adaptation of the enterprise model', *Global Strategy Journal*, vol. 6, no. 3 (2016), pp. 225–44.

Zott, Christoph, Amit, Raphael and Massa, Lorenzo. 'The business model: recent developments and future research', *Journal of Management*, vol. 37, no. 4 (2011).

Part Two

THE ENVIRONMENT OF INTERNATIONAL BUSINESS

Chapter 4

INTERNATIONAL POLITICS

Contents

Objectives of the chapter

Politics and economics are closely linked and often affect each other. Good examples include the tensions between the USA and China and across the European Union (EU) with the exit of the UK ('Brexit') from this economic and political union. Elsewhere, including parts of Asia, Latin America and Africa, political and social change are in constant tension with economic change. In some places

political institutions are evolving and maturing to provide stability and security to underpin economic growth and improved social welfare. Elsewhere the opposite is happening. The alternative path taken by China, alongside the effects of the Trump administration in the USA, have renewed interest in the relative costs and benefits of traditional democracies. The purposes of this chapter are to examine the linkage between political forces and economic change and then to review some of the major forms of economic integration that are being used to create regional trade areas and common markets. In future chapters these topics will be developed in more depth.

The specific objectives of this chapter are to:

1. *Compare and contrast* major political and economic systems and note the linkages among them.
2. *Examine* the primary reasons for the current privatisation movement and the economic impact that this movement is having on selected countries.
3. *Describe* the five major levels of economic integration and how each works.
4. *Discuss* how MNEs are using strategic planning to benefit from current worldwide economic integration efforts.
5. *Discuss* the impact of non-governmental organisations (NGOs) on international business.

ACTIVE LEARNING CASE

How risky is foreign investment in Russia?

Making investments in any foreign country is a risky business. Each and every foreign country has a different set of legal, political, social and economic institutions. Despite allegations that the world is flat, what we know is that there remains a large degree of variation in both country and regional institutional arrangements. So, no investor can afford to assume that doing business abroad is risk free. This logic applies to the current situation in Russia.

A number of problems continue to plague Russia. Natural resources account for approximately 70 per cent of the country's exports, including oil and natural gas, making the economy susceptible to world price fluctuations. The World Bank estimates suggest that not only do 30 per cent of the world's natural resources come from Russia but this is valued at a staggering $75 trillion US dollars. However, the banking system is weak and, after a series of crises dating back to 1998, this part of the economy is generally distrusted. In 2004, for instance, smaller banks faced a liquidity crisis as depositors, afraid for their savings, withdrew large sums of money. In addition, widespread corruption and government interference in the judiciary process stymies both domestic and foreign investment. The country ranks as 135th out of 175 countries in Transparency International's 'Corruption Perceptions Index' 2017 and among the worst in their 'Bribe Payers Index'.

A case in point is that of Yukos, one of Russia's largest oil companies, whose privatisation was one of many corrupt undertakings in the transition to a market economy. The government sought to collect back taxes that are threatening to bankrupt the company. Yukos is charged with tax evasion, but critics claim the move was politically motivated and that the tools used to evade taxes were perfectly legal under Russian law when they were undertaken.

By 2010, the former Russian oil tycoon Mikhail Khodorkovsky of Yukos was already serving an eight-year jail term for fraud and tax evasion. In the verdict of the second trial on 27 December 2010, he and his business partner Platon Lebedev were found guilty of stealing billions of dollars from their own oil firm, Yukos, and laundering the proceeds between 1998 and 2003. They would have to stay in jail until 2017. Many critics believe the government wants the former tycoon kept

behind bars for as long as possible because he challenged the president Vladimir Putin. As a result of this internal uncertainty, foreign investors continue to reassess their opportunities in Russia.

It is often argued that such political events in Russia make it far too dangerous a place to do business. This is not an accurate assessment of the political and economic situation in Russia. The nationalisation of key resource-based companies and the perceived inappropriate treatment of some foreign investors undoubtedly reflect an increase in Russian economic nationalism. But it is an easier place to do business than many would suspect. It ranked 35th out of 190 countries in the World Bank 'Ease of Doing Business' list in 2017 and 5th in the world in terms of 'Enforcing Contracts' in 2015, one of the key criteria (although this does fit the stereotype that many have of the country).

Source: Quentin Bargate/Alamy Stock Photo

The reason that Russian authorities will not engage in massive nationalisation of foreign assets is that the Russian economy remains dependent on foreign investment. Russia has large supplies of energy resources, but it needs to sell these to foreign consumers. Russia's resources will lose value if they are restricted to Russian consumers. There is as yet no economic evidence that Russia is seeking to be a self-contained, protected and isolated economy. Instead, it relies upon trade and foreign investment. However, at a time of increased concern over energy security, Moscow has more than once reminded the rest of the world of the power it yields as a major energy supplier. In the past it cut gas to Ukraine after a row between the countries – a move that also affected the supply of gas to western Europe. This then led to armed conflict in the region.

Today Russia is one of the largest economies in the world. It is attracting large amounts of foreign direct investment from members of the European Union, especially Germany and the UK. But the Russian government is thought to have an 'extensive shopping list of information' that it is trying to acquire through covert means – on the aerospace industry, defence and information technology, as well as in politics and diplomacy, and significant cross-border political tensions continue. A long-running dispute that began with the apparent murder of Alexander Litvinenko in London in November 2006 led to diplomats being expelled from both countries. It continued over ten years and in January 2016 the findings of a public enquiry strongly suggested that President Vladimir Putin approved the murder.

Despite this reversion to Cold War diplomacy, it is not anticipated that British investment in Russia will decrease. Nor is it expected that London will stop being a second home for many wealthy Russian businessmen. In short, the British/Russian political difficulties appear to make less of an impact on the economic relationship between the two countries than one would expect.

In contrast to the British case, US political relations with Russia have been more benign. There have been a number of bilateral trade and investment agreements between the two countries. The United States also helped Russia with its application to join the World Trade Organization. In general, US officials encourage US investment in Russia, and also welcome Russian investment in the United States. However, there have been concerns about Russia's involvement with the US especially about the alleged attack on hacked emails, social media fraud and suspected spies leading to the election of President Donald Trump in 2016. In fact, within three months of Trump winning the election the MSCI Russia Index increased by approximately 25 per cent. Given this relationship, it is unlikely that the US government will take any action to offset its ongoing concerns about human rights violations in Russia or an increase in Russian economic nationalism.

This long-run analysis of why Russia will remain an integral part of the world economic system does not mean that specific investment projects can escape risk. Russia is still at an early stage of economic development. It is not very long since the Berlin Wall crumbled and the former Soviet Union was opened to market forces. Russia has found it difficult to develop the appropriate market-based institutions to match its acceptance of worldwide capitalism.

Instead, Russia remains an autocratic regime, and foreign investors need to be careful in making commitments where the normal level and contractual arrangements available in the EU and North America do not yet fully exist. However, Russia is making progress in improving its institutional framework. Investors need to adopt a long-term view and should not be thrown off by short-term political developments in Russia. Foreign investors should seek to build lasting personal relationships with Russia's leaders in business and economics.

Websites: www.ford.com; www.imf.org; www.worldbank.org; www.tetrapak.de; www.pepsico.com; www.mcdonalds.com; www.yukos.com; www.telia.se; www.sonera.fi; www.telecominvest.com; http://www.transparency.org/cpi2014; http://www.doingbusiness.org/rankings; https://epthinktank.eu/2015/03/16/the-russian-economy-will-russia-ever-catch-up/eprs-ida-551320-russian-natural-resources/; https://business.financialpost.com/investing/investing-pro/why-investing-in-russia-could-remain-a-double-negative-for-investors; https://www.nytimes.com/interactive/2018/09/20/us/politics/russia-interference-election-trump-clinton.html.

Source: Adapted from Alan Rugman, 'Is it safe for Americans to invest in Russia?', Kansas City, *Sunday Star*, 7 October 2007; 'Cinderella's witching hour', *The Economist*, 8 July 2004; 'Court "freezes" key Yukos assets', *BBC News*, 19 April 2005; Russia Country Profile, news.bbc.co.uk; 'Prove my aid is Russian spy, says MP Mike Hancock', *BBC News*, 5 December 2010; 'Russia postpones verdict on oil tycoon Khodorkovsky', *BBC News*, 15 December 2010; 'Russian ex-tycoon Khodorkovsky appeals against jail term', *BBC News*, 31 December 2010; Transparency International, 2017 Corruption Perceptions Index, http://www.transparency.org; World Bank, Ease of Doing Business survey, 2017, http://www.doingbusiness.org/rankings.

1. **What type of economic system now exists in Russia: market-driven, centrally determined or mixed?**
2. **Would Russia benefit by gaining admission to one of the major economic unions such as the EU? Why?**
3. **Is Russia a good potential investment for Western business? Explain.**

INTRODUCTION

Over the past two decades, many countries have seen a dramatic change in their political systems. In general this has been characterised by a return to democracy for many developing and emerging economies and the development of more mature free market systems. Two significant examples are China and the Russian Federation. Each has a very different central government and governance system, but both have embraced free market economics and reforms are progressing across many fronts.

The movement towards market-driven economies of countries that were once controlled by the former Soviet Union is the result of historical political reforms. For example, Poland, Hungary, the Czech Republic, Latvia, Lithuania and Estonia, to name but six, have all created market-driven economies. Years ago the former Soviet Union would not have permitted these satellite nations to abandon the command economy advocated by communist ideology and replace it with a free market system. Under Mikhail Gorbachev, however, the Soviet Union revised its political and economic thinking – and things have never been the same since. Although this has proved to be good news for the satellite countries, Russia, as seen in this chapter's Active Learning Case, remains a complex place to do business. Complexity and uncertainty create risk, which MNEs have to constantly monitor.

China has been much more open to FDI, but still walks a fine line between commitment to its political philosophy and the need to attract outside investments. At the turn of the century, former President Jiang Zemin noted that one of the country's primary economic objectives is to increase gross domestic product at an annual rate of 7 per cent. During the interview, the

president also said that capitalists should be welcomed into the Communist Party.[1] At the same time, China encouraged foreign capital investment in order to ensure that its economic engine continued to function efficiently – this implied a change in its political ideology. One development in this direction was a government announcement that the country could no longer ensure the survival of inefficient companies. Firms now have to be able to compete with MNEs or face the risk of going under. Workers, accustomed to job security, had to accept the fact that they could be laid off and be willing to be retrained in order to find employment in this new, competitive job market.[2] These reforms have come a long way. In 2005 the private economy accounted for nearly 40 per cent of the gross product of Shanghai, China's largest urban centre.[3] By 2015 it accounted for over 60 per cent and now it accounts for over 85 per cent.

Successive governmental decrees have triggered significant changes in the way things have been done in China for the past 50 years. The same is true worldwide. International politics and economic integration are altering the way international business is being conducted, and those nations that cannot keep up with these developments are going to find themselves falling further and further behind. But economic growth is highly reliant on international political stability and the US–China trade war initiated by Donald Trump, alongside the effects of Brexit on the UK and mainland Europe, are recent examples of major political and economic destabilisations creating uncertainty which businesses need to adapt to.

Free markets underpin the development of both small and large multinational firms. As political and economic changes take place everywhere, new opportunities open up for MNEs in some countries, just as other countries become more closed or risky because of military conflicts or changes in the political ideology which work against foreign investors. Chapter 14 provides further discussion of political risks and international

business. In this chapter we will look at the major current economic and political systems and their impact on the world of international business. We will begin by examining political ideologies and economics.

POLITICAL IDEOLOGIES AND ECONOMICS

An **ideology** is a set of integrated beliefs theories, and doctrines that helps direct the actions of a society. Political ideology is almost always intertwined with economic philosophy. For example, the political ideology of the United States is grounded in the Constitution, which guarantees the rights of private property and the freedom of choice. This has helped lay the foundation for US capitalism. A change in this fundamental ideology would alter the economic environment of the United States. The same is true, for example, for China and the former Soviet Union republics. Simply put, the political and economic ideologies of nations help to explain their national economic policies.

Political systems

In the extreme, there are two types of political systems: democracy and totalitarianism. **Democracy** is a system of government in which the people, either directly or through their elected officials, decide what is to be done. Good examples of democratic governments include the United States, Canada, the UK and Australia. Common features of democratic governments include (1) the right to express opinions freely, (2) election of representatives for limited terms of office, (3) an independent court system that protects individual property and rights, and (4) a relatively non-political bureaucracy and defence infrastructure that ensure the continued operation of the system.

Totalitarianism is a system of government in which one individual or political party maintains complete control and either refuses to recognise other parties or suppresses them. A number of types of totalitarianism currently exist. **Communism** is an economic system in which the government

owns all property and makes all decisions regarding the production and distribution of goods and services. To date, all attempts at national communism have led to totalitarianism. Another form of totalitarianism is **theocratic totalitarianism**, in which a religious group exercises total power and represses or persecutes non-orthodox factions. Iran and some of the sheikdoms of the Middle East are seen by some as examples. A third form is **secular totalitarianism**, in which the military controls the government and makes decisions that it deems to be in the best interests of the country. North Korea is one example. Political systems typically create the infrastructure within which the economic system functions; in order to change the economic system, there often needs to be a change in the way the country is governed.

Economic systems

The three basic economic systems are capitalism, socialism and mixed. However, for the purposes of our analysis it is more helpful to classify these systems in terms of resource allocation (market-driven versus centrally determined) and property ownership (private versus public). In a **market-driven economy** (e.g. the US and the EU – and most countries) goods and services are allocated on the basis of demand and supply. In a **centrally determined economy**, goods and services are allocated based on a plan formulated by a committee that decides what is to be offered. In these economies people are able to purchase only what the government determines should be sold.

Market-driven economies are characterised by private ownership. Most of the assets of production are in the hands of privately owned companies that compete for market share by offering the best-quality goods and services at competitive prices. Centrally determined economies are characterised by public ownership. Most of the assets of production are in the hands of the state, and production quotas are set for each organisation.

In examining economic systems, it is important to remember that, in a strict sense, most nations of the world have **mixed economies**, characterised by a combination of market-driven forces and centrally determined planning. Mixed economies include privately owned commercial entities as well as government-owned commercial entities. Governments in mixed economies typically own the utilities, defence and often infrastructural industries – railways, airlines, shipping lines and industries considered to be of economic and strategic importance – for instance, petroleum and copper. For example, the United States, a leading proponent of market-driven economic policies, provides healthcare and other social services to many of its citizens through government-regulated agencies, which gives it some aspects of central planning. Other democratic countries with mixed economies include the UK, Sweden and Germany, all of which have even stronger social welfare systems than the United States.

Another role of government in the economy is that of promoting business and ensuring that local firms gain or maintain dominance in certain market areas. The US and EU governments continually pressure the Chinese to open their doors to foreign MNEs, and the Chinese government is very active in helping its local firms do business with the West.

As a result of such developments, there has been a blurring of the differences between market-driven and centrally determined economies. The biggest change has been the willingness of the latter to introduce free market concepts. Examples include Russia and other eastern European countries, which began introducing aspects of free enterprise such as allowing people to start their own businesses and to keep any profits that they make.[4] At the same time, however, many market-driven economies are increasingly adopting centrally determined ideas, such as using business–government cooperation to fend off external competitors, or political force to limit the ability of overseas firms to do business in their country. In the United States,

for example, the government is frequently being urged to play a more active role in monitoring foreign business practices. On balance, however, we are now seeing a move from central planning to market-driven and mixed economies.

GOVERNMENT CONTROL OF ASSETS

Privatisation is the process of selling government assets to private buyers. To understand the reasons for, and the economic impact of, this process, it is helpful to examine both the potential benefits of government ownership and the advantages of moving to privatisation.

There are six common, and sometimes interdependent, reasons for countries to control business assets – a process known as **nationalisation**. These comprise: (1) promoting economic development, such as by coordinating the assets of many businesses into one overall master plan; (2) earning profits for the national treasury; (3) preventing companies from going bankrupt and closing their doors; (4) enhancing programmes that are in the national interest; (5) increasing the political or economic control of those in power; and (6) ensuring goods and services to all citizens, regardless of their economic status.[5]

The opposite situation, privatisation, can take two forms. The most common form is **divestiture**, in which the government sells its assets. The other is **contract management**, in which the government transfers operating responsibility of an industry without transferring the legal title and ownership.

Some of the primary reasons for privatisation are: (1) it is more efficient to have the goods and services provided by private business than by government-run companies; (2) a change in the political culture brings about a desire to sell these assets; (3) the company has been making money, and the government feels there is more to be gained by selling now than by holding on; (4) the purchase price can be used to reduce the national debt; (5) the company is losing money, and the government has to assume the losses out of the national treasury; (6) the company needs research and development funds

in order to maintain a competitive stance and it is unwilling to make this investment; and (7) international funding agencies are making assistance to the country conditional on a reduction in the size of the government.[6]

INTERNATIONAL BUSINESS STRATEGY IN ACTION

Greece: third (bailout) time lucky

Greece adopted the euro as its currency in 2001. This began a turbulent monetary relationship with the rest of Europe, leading to a near-exit from the EU in 2015. Even though Greece had been an EU member since 1981, its annual budget deficit was never low enough to satisfy the Eurozone's Maastricht Criteria. Initially, like neighbouring Eurozone countries, Greece benefited with low interest rates and consistently received an inflow of investment capital and loans due to the financial power of the euro. However, in 2004, Greece announced that it had under-reported the level of its annual budget deficit in order to pass the Maastricht Criteria. Surprisingly, the EU did not permit any sanctions as other countries were also breaching regulations and it would not have been fair to sanction Greece without sanctioning the rest. Furthermore, the EU was uncertain of what sanctions to apply and overall did not want to weaken the power of the euro.

Despite these lessons Greece's debt continued to rise and in 2009 it became the epicentre of financial concerns in Europe as Greece again announced that it had been underestimating the scale of its budget deficit. The actual budget deficit was 12.9 per cent of GDP, over four times the EU's 3 per cent limit. Greece was forced to stop borrowing from financial markets and was heading towards bankruptcy. In 2010 it announced an austerity package designed to reassure the lending agencies that is was fiscally responsible and committed to lowering the deficit to just 3 per cent of the GDP. Sceptical of this commitment the EU, the European Central Bank and the IMF decided to provide €240 billion as emergency funds in return for greater levels of austerity measures in Greece. This allowed Greece to keep up to date with interest payments on existing debts, while keeping its banks afloat. However, these measures proved to be ineffective in the face of a slowing economy, with tax revenues falling, reducing the government's ability to pay off the debt, and unemployment rising to 25 per cent.

Following these events, the European Financial Stability Facility (EFSF) decided to provide Greece with an additional €190 billion to its original bailout in 2011. It was recorded that Greece's debt to GDP ratio had inclined to 175 per cent, which was almost three times greater than the EU's

limit of 60 per cent. In turn, bondholders agreed to a financial haircut, exchanging €77 billion in bonds for debts which were actually worth 75 per cent less.

With rioting in the streets, the tension between Greece and other European countries created an opportunity for the leftist Syriza party to win power. It rode a national wave of sentiment that blamed austerity measures forced on Greece by its creditors as the cause of the country's problems, rather than the solution. For a short while this seemed to blind the government and the nation to the harsh financial realities of indebtedness.

In 2017, Greece's debt to GDP ratio was estimated to be around 180 per cent. In addition, in 2015 the government missed two deadlines to pay almost €1.6 billion in debt interest on loans it had already received and it became the first Western economy to miss an IMF loan repayment. Greece's public debt was stated as highly unsustainable by the IMF. Furthermore, the IMF suggested this was down to deterioration in the domestic macroeconomic and financial environment due to the closure of the banking system. These poor economic factors resulted in a political debate determining whether Greece would remain in the EU. During mid-2015, with the help of the IMF, the European Stability Mechanism (ESM) decided to bail out Greece again, with a loan of €86 billion. Launched in 2012, the ESM is the Eurozone's only bailout fund, which is financed by all 19 member states and has Germany as its largest ESM contributor (€190 billion).

However, things may be taking a turn for Greece as in 2018 European Union authorities in Brussels declared that Greece had ended its eight-year bailout programme and the nation became 'a normal' member of the single currency. This is quite promising, as the three bailouts almost ejected the nation from the single currency. Pierre Moscovici, who was the European commissioner for economic and financial affairs, stated that Greece was starting a new chapter after eight 'very difficult' years. Overall, as the Greek situation has evolved it has proved to be the most important lesson so far on the risks of operating a single currency across independent economies with their own monetary policies and different levels of fiscal discipline.

Websites: www.bbc.co.uk, www.nytimes.com, www.economist.com

Source: Robert Peston, 'Third time lucky for Greece?', *BBC Business News*, 11 August 2015; 'Greece debt crisis: bailout deal at a glance', *BBC Business News*, 13 July 2015; 'Greece debt crisis: IMF attacks EU over bailout terms', *BBC Business News*, 15 July 2015; 'Greece's debt crisis

explained', International Business, *New York Times*, 9 November 2015; 'Greece and the euro: a third bail-out gets the green light', *The Economist*, 15 August 2015; Jennifer Rankin, 'EU says Greece can 'finally turn the page' as bailout ends', *The Guardian*, 20 August 2018.

GOVERNMENT–BUSINESS COOPERATION

Whether governments are privatising or nationalising assets, they need to maintain a range of controls and mechanisms for coordination and cooperation in place to connect public policy with private sector investments and decision making. National and regional industrial strategies aim to focus investment into key sectors where local advantages either help attract inward investment or support export-led growth.

Japan and EU assistance

The Japanese Ministry of International Trade and Industry (MITI) put in place a focused industrial policy, funding research and directing investment from the 1950s onwards. In 2001 it became the **Ministry of Economy, Trade and Industry (METI)**. The initial focus of the ministry was to provide protection to Japanese companies and to assist in marketing the products of four major industries: electric power, steel, shipbuilding and fertilisers. Incentives were created to encourage investment in these industries and to help firms export their products. METI's approach is less proactive ('command and control') and more cooperative.

The governments of EU member nations co-invest and cooperate in trade agreements, joint research and development (R&D), labour mobility agreements and both industry sector and regional development initiatives for their collective benefit. Since the early days of the EU its approach has shifted from a more narrow focus on subsidising agriculture, technology support and firm performance and competitiveness to include more initiatives on sustainability, well-being and reducing inequality. Developing skills and

innovation alongside a 'smart specialisation' strategy for specific regions still lies at the heart of the EU approach.[7]

US competitiveness

The results of such governmental efforts have not been lost on Washington, which has long recognised the value of an industrial policy that provides benefits similar to those offered by METI and EUREKA. National government agencies work with academics and businesses to develop long-range strategic plans to focus government funding on technologies that are predicted to be central to future economies growth and well-being.

In the past, US administrations have supported research efforts that promoted industrial competitiveness and technological leadership. This often took one of two paths: (1) the funding of military research that could then be used to create commercially useful products; or (2) the direct funding of research efforts by US firms. The technology policy of the Obama and Trump administrations has been to continue maintaining a strong focus on technology and progress has been made in the areas of: cybersecurity and internet policy; modernising patent systems; transforming technology 'from lab to market'; advanced manufacturing robotics; and open data initiatives.

Active learning check

Review your answer to Active Learning Case question 1 and make any changes you like. Then compare your answer to the one below.

1 What type of economic system now exists in Russia: market-driven, centrally determined or mixed?

A mixed system currently exists. The country is moving away from a centrally determined economy, but there is a long way to go. As can be seen from the information in the case, the transition is causing a great deal of economic upheaval. This may even result in a regression towards some of the previously employed, centrally determined decision making. However, the country is not going to go back to the old way of doing things because it has too much committed to its current course of action. In particular, any further IMF loans or assistance from the United States, Japan or the EU will depend on how well the country is holding the line and trying to make its market-driven economy work. So a mixed economic system will remain in place; in fact, this is really the only path the Russians can take in rescuing their economy.

ECONOMIC INTEGRATION

Economic integration is the establishment of transnational rules and regulations that enhance economic trade and cooperation among countries. At one extreme, economic integration would result in one worldwide free trade market in which all nations had a common currency and could export anything they wanted to any other nation. At the other extreme would be a total lack of economic integration, in which nations were self-sufficient and did not trade with anyone. (The theory of these polar extremes will be discussed in Chapter 6.)

The concept of economic integration is attractive, but there are many implementation problems. In particular, it requires that the participants agree to surrender some of their national sovereignty, such as the authority to set tariffs and quotas. For example, if the United States and the EU agree to allow free trade of agricultural products, neither can restrict the other's right to export these commodities. So although free trade may lead to lower prices, those who are unwilling to give up the right to control goods being imported into their country may well be opposed to it.

A number of regional economic efforts have been undertaken over the past 30 years to promote varying degrees of economic integration. The most successful, until recently has been the EU, although less developed countries (LDCs) have also made integration efforts.

Trade creation and trade diversion

Before examining economic integration in more depth, it is important to realise that the agreement of countries to integrate their economies will bring

about a shift in business activity. This shift can result in trade creation as well as trade diversion.

Trade creation occurs when members of an economic integration group begin focusing their efforts on those goods and services for which they have a comparative advantage and start trading more extensively with each other. For example, the United States and Mexico have an agreement that allows cars to be assembled in Mexico and shipped to the United States. As a result, Mexico, a low-cost producer, supplies a large number of vehicles sold in the United States, and both countries prosper as a result.

Trade creation results in efficient, low-cost producers in member countries gaining market share from high-cost member producers, as well as generating increased exports. In fact, a growing number of US companies have moved some of their operations to Mexico or hired Mexican firms to be their suppliers because this is a more efficient approach than making the goods in the United States. And when efficient regional producers are able to offer lower-price and higher-quality output than their competitors, trade creation results.

Trade diversion occurs when members of an economic integration group decrease their trade with non-member countries in favour of trade with each other. One common reason is that the removal of trade barriers among member countries makes it less expensive to buy from companies within the group, and the continuation of trade barriers with non-member countries makes it more difficult for the latter to compete. Thus, trade diversion can lead to the loss of production and exports from more efficient non-member countries to less efficient member countries that are being protected by tariffs or other barriers. Quite obviously, the creation of economic integration groups is beneficial only if trade creation exceeds trade diversion. Otherwise, the economic union impedes international trade.

Levels of economic integration

There are five levels of economic integration, which extend from simple economic trade arrangements to full political integration characterised by a single government. The following examines each of these levels, beginning with the simplest.

Free trade area

A **free trade area** is an economic integration arrangement in which barriers to trade (such as tariffs) among member countries are removed. Under this arrangement, each participant will seek to gain by specialising in the production of those goods and services for which it has a comparative advantage and importing those goods and services for which it has a comparative disadvantage.

One of the best-known free trade areas is the **North American Free Trade Agreement (NAFTA)**, which currently consists of Canada, the United States and Mexico. NAFTA covers a North American economy with a combined output of US$25 trillion in 2018.[8] The United States and Canada created this free trade area with the US–Canadian Free Trade Agreement of 1989, and the arrangement has now been expanded to include Mexico.[9] While trade diversion can occur under free trade arrangements, NAFTA has led to a great amount of trade creation. In fact, trade among the three members of NAFTA is over $1 trillion annually![10]

President Trump took a number of steps away from the free trade vision, towards protectionism, blaming NAFTA for job losses and the decline of manufacturing. In 2018 his administration updated the pact, to become the US–Mexico–Canada Agreement, or USMCA.

Customs union

A **customs union** is a form of economic integration in which all tariffs between member countries are eliminated and a common trade policy towards non-member countries is established. This policy often results in a uniform external tariff structure. Under this arrangement, a country outside the union will face the same tariff on exports to any member country receiving the goods.

Under a customs union, member countries cede some of the control of their economic policies to the group at large. None of the regional integration groups in existence today has been formed for the purpose of creating a customs union; instead, many of them have sought greater integration in the form of a common market or economic union. However, because of the difficulty of attaining this high degree of integration, some countries have effectively settled for a customs union.

Common market

A **common market** is a form of economic integration characterised by: (1) no barriers to trade among member nations; (2) a common external trade policy; and (3) mobility of factors of production among member countries. A common market allows reallocation of production resources, such as capital, labour and technology, based on the theory of comparative advantage. Although this may be economically disadvantageous to industries or specific businesses in some member countries, in theory it should lead to the efficient delivery of goods and services to all member countries. The best example of a successful common market is the EU, although this group has now progressed beyond a common market and is now focusing on political and financial integration. Brexit and other destabilising events have created a new set of tensions across the EU, undermining progress towards further integration.

Economic union

An **economic union** is a deep form of economic integration and is characterised by free movement of goods, services and factors of production among member countries and full integration of economic policies. An economic union (1) unifies monetary and fiscal policy among the member nations, including the same tax rates, and (2) has a common currency (or a permanently fixed exchange rate among currencies). Additionally, most of the national economic policies of the individual countries are ceded to the group at large. There are no true economic unions in the world, but the creation of a single currency, the euro, certainly moved the EU in this direction.

Political union

A **political union** goes beyond full economic integration to encompass a single government. This occurs only when countries give up their individual national powers to be united and led by one government. One successful example is the United States, which combined independent states into a political union. The EU is now also on its way to becoming a political union. The European Parliament, for example, is directly elected by citizens of the EU countries, and its Council of Ministers, which is the decision-making body of the EU, is made up of government ministers from each EU country.

Economic integration: an overall perspective

Before concluding our discussion of levels of economic integration, four points merit consideration. First, a country does not need to pursue economic integration by starting with a free trade area and then working up to a common market or an economic union. For example, the UK was a member of a free trade area before deciding to leave and enter the EU. Many years later, in 2016 the country decided to leave the EU. Simply stated, countries will choose the appropriate level of economic integration based on their political and economic needs.

Second, economic integration in the form of free trade typically results in a winning situation for all group members, since each member can specialise in those goods and services it makes most efficiently and rely on others in the group to provide the remainder. However, when a bloc of countries imposes a tariff on non-members, this often results in a win–lose situation. Those outside the bloc face tariffs, are thus less competitive with group member companies, and lose market share and revenue within the bloc. Among group members, however, increased competition often results in greater efficiency, lower prices, and increased exports to non-member markets.

Third, and complementary to the above, bloc members often find that their businesses are able to achieve **internal economies of scale** brought about by lower production costs and other savings. So if a company in France was only moderately efficient when producing 1,000 units a week for the French market, it is now highly efficient producing 4,000 units a week for countries throughout the EU. The elimination of tariffs and trade barriers and the opening up of new geographic markets allow the company to increase production efficiency. In addition, since factors of production in a common market are allowed to flow freely across borders, the firm may also achieve **external economies of scale** brought about by access to low-cost capital, more highly skilled labour, and superior technology. In short, in-group companies can draw on resources in member countries to help increase efficiency.

Finally, in the short run, some bloc countries may suffer because other member countries are able to achieve greater efficiency and thus dominate certain industries and markets in the bloc. The adjustment period may last as long as a decade as these less efficient countries scramble to improve their technologies, retrain their workforces and redirect their economies to markets in the bloc where they can gain and sustain an advantage vis-à-vis other

members. In the long run, however, economic integration results in all bloc countries becoming much more efficient and competitive.

Despite the logic of free trade and economic integration, many **non-governmental organisations (NGOs)** criticise MNEs and international institutions. We now discuss these issues. See also the case **International Business Strategy in Action: Non-governmental organisations and political power**.

Ethics, environment, MNEs and the civil society

The **civil society** is a group of individuals, organisations and institutions that act outside the government and the market to advance a diverse set of interests, including opposition to global business. Demonstrations against trade and investment agreements are mainly composed of environmentalists, anti-poverty campaigners, trade unionists and anti-capitalists that are either part of an NGO or trade union, or simply individuals that share their views.[11] The lack of a common front across these organisations meant that, while some protestors are chanting and throwing roses, others are throwing rocks and charging at the police. The more extremist groups would like to see an end to multinationals and international trade. More moderate demonstrators would like a transformation in the rules of trade with less developed nations, debt forgiveness and better labour and environmental standards.[12] Protestors also have different agendas. Trade unionists from developed countries are concerned about the alleged loss of jobs due to globalisation, whereas human rights NGOs are much more concerned with the situation of workers in less industrialised nations.

NGOs and civil society organisations (CSOs) more generally have gradually matured to become institutions which government agencies and companies need to engage with. The 2015 United Nations Summit of NGOs saw a large number from a wide variety of thematic associations discussing

their shared interests. Coalitions of NGOs have also evolved, like EURODAD.[13] EURODAD is the European Network on Debt and Development, a network of 54 NGOs from 17 European countries with a shared interest in debt, development finance and poverty reduction. It has recently focused on ‘multilateral debt cancelation, debt sustainability, aid quality, conditionality and harmonisation, and export credit debts’.[14]

INTERNATIONAL BUSINESS STRATEGY IN ACTION

Businesses and NGOs work together on climate change

When the topic of politics in the international business arena is discussed, topics including the impact of the government on international trade and the regulation of multinational enterprises (MNEs) are frequently part of the conversation. In recent years another topic that has become more popular is the role of non-governmental organisations (NGOs), which have been gaining an increasing amount of political power.

An NGO is a non-profit organisation run by volunteers with a specific mandate at a local, national or international level. As such, NGOs take a number of different forms. Some are very large, such as the environmental group Greenpeace, the World Wide Fund for Nature (WWF) and Amnesty International, whereas others are smaller and less well known. This case study illustrates the power that NGOs can have over nations, especially when these NGOs team up with large MNEs.

Climate change has been growing in importance following the Paris Agreement. The Paris Agreement was an agreement that was made in 2015 among the United Nations Framework Convention on Climate Change. This agreement concerns mitigating greenhouse gas emissions, adaptation and finance, which is planned to start in 2020. In 2018 a group of businesses decided to join forces with local authorities and NGOs to urge EU leaders to accelerate the transition to a zero-carbon economy to keep global warming below 2°C. This was the main message that was put forward to EU leaders in mid-2018, in a letter sent by ‘Coalition for Higher Ambition’. The letter contained three recommendations:

- Finalise adoption of the EU’s clean energy package of legislation for 2030.
- Adopt a long-term EU climate strategy that sets Europe on a pathway to deliver on the 1.5°C objective of the Paris Agreement. However, this must include zero emissions targets by 2050.
- Revise the EU’s 2030 greenhouse gas emissions reduction target in order to allow the EU to resubmit its Paris pledge to the UN by 2020.

The coalition includes the Corporate Leaders Group, which represents key businesses operating in Europe and the Climate Group. It brings together businesses and governments at the global level, with the Institutional Investors Group on Climate Change representing over €21 trillion in assets.

As the coalition represented a diverse mix of actors, environmental NGOs, which are usually sceptical concentring the motives of businesses when tackling climate change, have also joined the group of signatories. Some of the NGOs include Climate Action Network (CAN) Europe, Plan B and Heal. Furthermore, local and regional authorities are also represented through the Climate Alliance, which brings together 1,700 municipalities and mayors from across the world who are committed to reducing greenhouse gas emissions by 10 per cent every five years.

The Director of Climate Action Network Europe, Wendel Trio, asserted that together the coalition believes that to truly achieve the implementation of The Paris Agreement, further reductions in emissions are required, beyond those currently planned. As of 2018, policy-makers in Europe are discussing a package of laws that will encompass the EU's energy and climate policy. Initially, it will include targets on three main factors, namely, greenhouse gas emissions, energy efficiency and renewable, and will be in effect until 2030. Although some countries, such as France, Sweden and the Netherlands have embraced this initiative, other nations have not been so welcoming of it. For instance, the Czech Republic, Slovakia, Hungary and Poland have all expressed concerns about this package by stating that its targets are not only unachievable, but extremely costly. Germany also expressed concerns that targeting renewable energy usage of 32 to 35 per cent by 2030 is unrealistic, and is significantly higher than the 27 per cent objective agreed by EU leaders in 2014.

However, some NGO alliances have suggested that only meeting the targets set in 2014 is rather short-sighted. For instance, the Director of The Prince of Wales's Corporate Leaders Group, Eliot Whittington, advocated that as more firms are demonstrating innovative practices in dealing with environmental issues, surpassing expected targets is not only possible but better for everyone, including businesses in the long run. Whittington also asserted that if this is to be achieved, policy-makers need to act now and set future direction.

Given climate concerns, the S&P 500 released a report on this matter and found that many CEOs are not only acknowledging the importance of climate risk, but management teams are seeking ways to minimise the impact of climate risk. Although 73 companies from the S&P's 500 list publicly

disclosed the impact on earnings from weather events, only 18 companies actually quantified those effects. Therefore, there is some way to go concerning climate risks, which makes the demands from the 'Coalition for Higher Ambition' more important than ever.

Source: Websites:https://www.euractiv.com/section/energy/news/businesses-ngos-make-joint-plea-for-higher-eu-ambition-on-climate-change/; https://ec.europa.eu/clima/news/cop24-eu-and-allies-breakthrough-agreement-step-ambition_en; https://www.businessgreen.com/bg/news/2449471/new-coalition-for-higher-ambition-calls-on-eu-to-step-up-efforts-to-honour-paris-agreement www.oecd.org.

These recent events show that the gulf between the agendas of NGOs and corporations as the economic drivers of global business is narrowing. There is no doubt that important conflicts of interest exist.[15] This is related to a traditional divide between the redistribution and equity concerns of NGOs and the economic and efficiency issues that drive business. Democratic governments in Western economies have incorporated these dual concerns in their political platforms, and, at least as part of a broader political package, voters have some say through the electoral process.

Complementary to the NGOs' perspective on international trade and investment is the intellectual failure of academic theory, in which the twin basic paradigms of economics and politics are found to develop explanations of today's global economy and the nature of foreign direct investment (FDI). In economics, the traditional efficiency-based neo-classical paradigm (with its associated theory of comparative advantages and the overall country gains from free trade) is unsuitable as an explanation of FDI. Despite the efforts by international business writers over the last 30 years to develop a modern theory of the MNE, most economists are unable to accept this explanation of the reasons for FDI. As a consequence, the GATT and WTO have developed institutional frameworks to deal with the 'shallow' integration of tariff cuts, but have failed to deal with the 'deep' integration of FDI.

The European Union (EU)

After World War II, Europe needed to be rebuilt and economic cooperation among these countries was paramount. Six countries (Belgium, France, Italy, Luxembourg, the Netherlands and West Germany) created the **European Coal and Steel Community (ECSC)** and its success set the stage for the creation of what would eventually become the European Union.

The foundation of the European Union was laid in 1957 by the Treaty of Rome. The six nations that created the ECSC were the original founders of what was initially called the European Economic Community (EEC) and later the European Community (EC). By 1991 six other nations had joined the EC (the UK, Denmark, Greece, Ireland, Portugal and Spain) – and in 1995 with the admission of Austria, Finland and Sweden, the EC was renamed the **European Union**. In 2004, ten new members joined the EU: Cyprus, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, Slovakia and Slovenia. In 2007 Bulgaria and Romania joined, followed much later by Croatia in 2013. Today the EU is a major economic group including over 500 million people, and a growing number of countries have applied for admission.

The main provisions of the founding treaty of 1957 were as follows:

1. Formation of a free trade area among the members would be brought about by the gradual elimination of tariffs, quotas and other trade barriers.
2. Barriers to the movement of labour, capital and business enterprises would eventually be removed.
3. Common agricultural policies would be adopted.
4. An investment fund to channel capital from the more advanced regions of the bloc to the less advanced regions would be created.

5 A customs union characterised by a uniform tariff schedule applicable to imports from the rest of the world would be created.

Some of the countries that were not members of the initial EEC felt that the objectives of this group went beyond what they were willing to do, but they did feel that a free trade agreement would be good for their own economies. As a result, these nations formed the **European Free Trade Association (EFTA)**, whose primary goal was to dismantle trade barriers among its members. Austria, Denmark, Norway, Portugal, Sweden, Switzerland and the UK were the founding members. In time the distinctions between EFTA and the EC blurred, however, and some of the members (Austria, Denmark, Portugal, Sweden and the UK) eventually joined the EC. Moreover, in 1992 EFTA signed a treaty that formally gives its members an economic association with the EU. Today EFTA members include Iceland, Liechtenstein, Norway and Switzerland.

Organisation

The major institutions managing the EU are: the European Council, the Council of the European Union, the European Commission, the European Parliament, the Court of Justice and the Court of Auditors (see Figure 4.1). A brief list of each of these is set out below, but a full range of current facts and figures are at www.europa.eu.

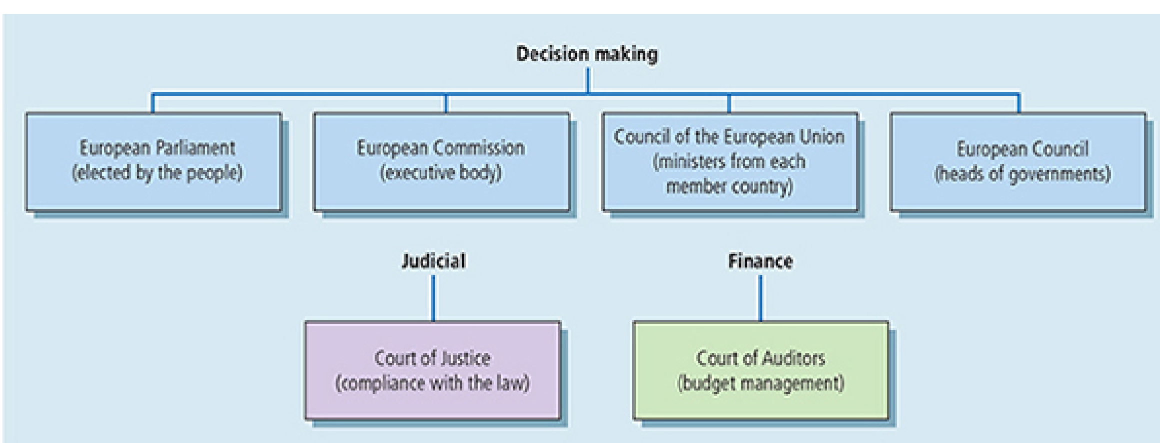

Figure 4.1 The European Union's institutions

- The **European Council** is composed of the heads of state of each EU member country as well as the president of the European Commission. It resolves major policy issues and sets policy direction.
- The **Council of the European Union** is the major policy decision-making body of the EU. This body is responsible for all final EU decisions, except for the budget.
- The **European Commission** currently has 28 members who are chosen by agreement of the member governments, each representing one country in the EU. It is the executive branch of the EU, handles a great deal of the technical work associated with preparing decisions and regulations and legislation.
- The **European Parliament** currently has 751 members; 750 elected directly by the voters in each member country and one EU President. The Parliament serves as a watchdog on EU expenditures in addition to evaluating other decisions of the Council.
- The **Court of Justice** has one judge appointed from each EU member country and serves as the official interpreter of EU law. It has supremacy over national law and as a result it is increasingly being used as a court of appeal over national decisions.
- The **Court of Auditors** has one judge appointed from each EU member country and is responsible for ensuring that revenues and expenditures are implemented lawfully in accordance to the budget.

Growth and challenges

Over the years, the EU has made vigorous headways in pursuit of its objectives, gradually reducing the formal barriers to the free flow of labour and capital and developing common strategies and centralised funding for defence, social welfare and industrial strategies. The single European

currency, the euro, was introduced to replace most national currencies. Closely linked to this was the establishment of a central European bank that regulates the money supply and is thus able to stabilise interest rates throughout the EU. The effect of these actions may well be the creation of a 'United States of Europe'.

However, the EU still faces a number of problems. One general disagreement among the members relates to the relationship that should exist between the community and the rest of the world. This has recently challenged the unity of EU members as they faced the difficult challenge of overwhelming volumes of inward migrants. This influx was partly fuelled by political upheavals in the Middle East and specifically Syria, creating unprecedented levels of refugees which EU member states had an ethical and humanitarian obligation to accept. These came alongside a growing flow of economic migrants, looking for better employment opportunities and to gain access to state-subsidised housing, health and welfare benefits. Sharing the costs of dealing with migrants, across a set of countries with very different levels of resources for coping with the influx, tested the EU concord to its limits.

Another problem is the protection that countries give to their own industries, which is in direct contrast to the spirit of EU rules. A related area is the community's agriculture policies, which provide subsidies and rebates to farmers and have resulted in charges of unfair trade practices. There is also disagreement among the members regarding the amount of protection that poorer countries should be given before all trade barriers are dismantled. The Greek debt crisis in 2015 was related to this dilemma (see the case **International Business Strategy in Action: Greece**, above) and illustrates the major challenges of operating a monetary union with a single currency.

Even if all its goals have not been fully realised, the EU arguably remains the most powerful economic coalition in the international arena. Taken as a

whole, it has 7 per cent of the world's population, but is the largest economy and the largest participant in global trade, accounting for about 20 per cent of global imports and exports. About two-thirds of EU countries' trade is with other EU member countries.

Brexit

In 2016 the British public voted via a national referendum to leave the European Union. On 29 March 2017 the UK invoked Article 50 of the Treaty on European Union (TEU) to begin its withdrawal, commonly known as **'Brexit'**, giving it two years before the country would cease being a member of the EU. Since then the UK has witnessed an unprecedented period of economic and political uncertainty.

The event and its repercussions have demonstrated the overwhelming need to understand two important dimensions of the global economy. First, that social and economic inequalities are major drivers of political discontent. Growing inequalities, for example between London and other city-regions in the UK, have been shown to be the underlying forces behind a popular backlash against wealthy elites and the unfairness of capitalist systems. The Brexit vote and the vote for Donald Trump in the USA were very clear expressions of resentment and opposition against those benefitting from the global system from those not benefitting. They have triggered a protectionist movement in the USA and elsewhere and an era of soul-searching in the UK.

The second dimension highlighted by these events is that relatively few people (including many managers as well as politicians) fully understand the real benefits of political and economic integration, some of which result from freer trade and low-friction borders, but also include a wide range of economies of scale (such as in defence, legal and regulatory institutions, and in scientific and technological development), political cooperation and cultural understanding. In Chapter 6 we examine the massive complexities of

unravelling decades of open trade legislation to establish tariff and non-tariff barriers between the UK and the EU, including Ireland. This where politics directly affects business, through the costs of uncertainty and the extra costs of operating global value chains across hard borders.

Other examples of economic integration

While the EU is (possibly still) the most successful economic union, there are a host of others. The following briefly examines a few of these.

Andean Community

The **Andean Community** is a customs union that was formed in 1969 with the signing of the Andean Pact by Bolivia, Chile, Colombia, Ecuador and Peru. Venezuela was a member from 1973 to 2006, and Chile has withdrawn but remains an associate member country (www.comunidadandina.org). The union is also known as Comunidad Andina (CAN) or Andean Community (Ancom). The original objectives of the CAN countries were to integrate themselves economically, to reduce internal tariffs, to create a common external tariff, and to offer special concessions to the two smallest members, Bolivia and Ecuador.

Mercosur

Mercosur is a free trade group that was formed by Argentina and Brazil in 1988 to promote economic cooperation. Today the group has been expanded to include Venezuela, Paraguay and Uruguay, with Chile, Colombia, Ecuador and Peru as associate members. In 2012 and 2015 Bolivia also signed the Accession Protocol and its membership status is 'in accession process'. The members agreed to a five-year programme under which they hoped to perfect their free trade area and move towards a full customs union but this has not evolved smoothly.

Mercosur and the Andean Community agreed in principle to work towards a ‘South American Community of Nations’ that will encompass 360 million people and a GDP of $1 trillion. First, however, these countries must resolve their differences.[16]

Asean

The **Association of South-East Asian Nations (ASEAN)** was founded in 1967 and now includes Brunei Darussalam, Cambodia, Indonesia, Lao PDR, Malaysia, Myanmar, the Philippines, Singapore, Thailand and Vietnam. This economic bloc is different from most others in that the primary emphasis is not on reducing trade barriers among the members, although this has been done with the agreement on the ASEAN Free Trade Area (AFTA), but rather on promoting exports to other countries.

✔ Active learning check

Review your answer to Active Learning Case question 2 and make any changes you like. Then compare your answer to the one below.

2 Would Russia benefit by gaining admission to one of the major economic unions such as the EU? Why?

Russia certainly would benefit by gaining admission to an economic union such as the EU. It could then take advantage of a wide variety of benefits, including free movement of goods and services across borders, trade creation, the possible development of internal economies brought about by the huge market that would then be available for Russian goods, and a strengthening of the nation's currency. Of course, admission to the EU or one of the other major economic unions is unlikely to occur, at least within the next few years, as the country is not stable. However, it would offer a very big boost to the nation's economy.

Active learning check

Review your answer to Active Learning Case question 3 and make any changes you like. Then compare your answer to the one below.

3 Is Russia a good potential investment for Western business? Explain.

Arguments can be made on each side. Untapped natural resources and potential consumer demand could provide billions of dollars of annual sales for investing companies. On the other hand, the economy is in terrible shape, and it is likely to take years before Russia begins to provide an acceptable return on investment for many current projects. One of the major reasons for getting in now, of course, is to try to gain a strong foothold in the market and effectively block future competition. If this should happen, those coming later would find slim pickings. However, this potential benefit is unlikely to attract many investors. Most are likely to conclude that the best strategy is to proceed with caution and wait for the current uncertainty and turmoil to settle.

KEY POINTS

1. Political ideologies and economic systems are interwoven. Democracies tend to have market-driven economies; totalitarian governments tend to have centrally determined economies. However, few nations fit totally into one of these two paradigms. Most use a mixed economic model such as that of the United States, which is mainly a market-driven economy with some central planning, or China, which has a combination of both.
2. The degree to which assets and enterprises are state-owned or controlled, versus privately-owned is a key measure of its political governance structure. Centrally-planned economies, or countries where the state exerts a high degree of control over firms and institutions are very different contexts for doing business compared to more liberal, market-driven economies.
3. State ownership can be beneficial if it helps national security and the well-being of the people, or for economic reasons, including (a) increased efficiency, (b) reduction in government outlays and (c) generation of funds for the national treasury.
4. Economic integration is the establishment of transnational rules and regulations that permit economic trade and cooperation among countries. Effective integration brings about trade creation, although in some cases these efforts result in trade diversion. There are five levels of regional economic trade integration: free trade areas, customs unions, common markets, economic unions and political unions. The most successful examples have been the EU and the NAFTA.
5. NGOs are important actors on the stage of international business, and MNEs need to take account of corporate responsibility and the civil

society in their strategies.

Key terms

- **ideology**
- **democracy**
- **totalitarianism**
- **communism**
- **theocratic totalitarianism**
- **secular totalitarianism**
- **market-driven economy**
- **centrally determined economy**
- **mixed economies**
- **privatisation**
- **nationalisation**
- **divestiture**
- **contract management**
- **Ministry of Economy, Trade and Industry (METI)**
- **economic integration**
- **trade creation**
- **trade diversion**
- **free trade area**
- **North American Free Trade Agreement (NAFTA)**

- **customs union**
- **common market**
- **economic union**
- **political union**
- **internal economies of scale**
- **external economies of scale**
- **non-governmental organisations (NGOs)**
- **civil society**
- **European Coal and Steel Community (ECSC)**
- **European Union (EU)**
- **European Free Trade Association (EFTA)**
- **European Council**
- **Council of the European Union**
- **European Commission**
- **European Parliament**
- **Court of Justice**
- **Court of Auditors**
- **Brexit**
- **Andean Community**
- **Mercosur**
- **Association of South-East Asian Nations (ASEAN)**

REVIEW AND DISCUSSION QUESTIONS

1. As political systems change, economic systems follow. What does this statement mean?
2. How does a centrally determined economy differ from a market-driven economy? Explain.
3. What are the benefits of privatisation? Why will the trend towards privatisation continue?
4. Why are government–business cooperative efforts beginning to increase? What benefits do they offer?
5. What is the purpose of research consortia? What is their future likely to be? Why?
6. How does trade creation differ from trade diversion? Compare and contrast the two.
7. There are five levels of economic integration. What is meant by this statement? Be complete in your answer.
8. How does the EU function? Identify and describe its organisation and operation.
9. What is the purpose of the following economic alliances: the Andean Community, Mercosur and ASEAN?
10. What are the causes of Brexit and what has it revealed about the politics of economic integration?

REAL CASE

How environmental regulations can be used as trade barriers

With free trade areas evolving around the globe, many protected industries are now facing unwelcome competition. Free trade agreements generally include a principle of national treatment under which a country must treat all producers, domestic or foreign, equally. However, some seemingly neutral environmental regulations impose a greater burden on foreign producers than on their domestic competitors. Thus, they act as trade barriers under the disguise of environmental regulations.

For example, while environmental groups lobby for newsprint to contain a determined amount of recycled material and domestic producers of newsprint support the regulation, foreign newsprint companies, which have no recycling facilities in the host country, face a competitive disadvantage. This is what has been called a 'Baptist–bootlegger' coalition. During the US prohibition era, Baptists were opposed to alcoholic consumption on moral grounds, while bootleggers actually benefited from prohibition by the sale of illegal alcoholic beverages. Today, environmental groups and domestic producers often form coalitions to promote their respective interests.

In the newsprint case, the foreign company would have two options if it were to continue to supply material from its home country. It could either open recycling plants in the host country and transport pulp from its own country to be processed there, so as to meet the environmental regulations, or take the recycling material to its home country to be processed. Both alternatives would pose significant transportation costs to the foreign producer.

A similar case is presented by the Ontario Beer Can Tax. In the early 1990s the province of Ontario levied a tax of $0.10 on each aluminium beer can. The province argued that these cans were not environmentally friendly and that the tax was designed to encourage the use of refillable glass bottles. US producers of beer and aluminium cans contended that this was a protectionist move and that the Ontario government was singling out the competition with its beer industry since it had no similar tax for soft drinks and juice cans. Moreover, research studies found that aluminium cans and glass bottles both have the same effect on the environment, and that 80 per cent of all the cans were

being recycled. They also found that the larger, heavier glass required more energy to transport than did the lighter aluminium cans.

More recently, the UK government received a report to impose a new tax on businesses that use virgin plastic packaging. Virgin packaging refers to fresh plastic that has not been manufactured into a product. Once manufactured, then the plastic product can be recycled. World Wide Fund for Nature (WWF) and the Resource Association commissioned environment group Eunomia to issue the report. The disposal of plastic has received new levels in the UK; this is because China recently banned the import of plastic waste. Given this, the UK has been chasing markets such as Malaysia, Vietnam and Thailand. However, these countries are now also imposing their own restrictions on plastics due to excessive stockpiling of waste. The majority of plastic waste from the UK has been going to Turkey and the nation continues to struggle to find other markets due to environmental restrictions.

Websites: https://www.theguardian.com/environment/2018/nov/20/tax-virgin-packaging-tackle-plastics-crisis-report

Sources: Adapted from Alan M. Rugman, John Kirton, and Julie Soloway, *Environmental Regulations and Corporate Strategy: A NAFTA Perspective* (Oxford: Oxford University Press, 1999); M. Trebilcock and R. Howse, 'Trade policy and domestic health and safety standards', in *The Regulation of International Trade*, 2nd ed. (London: Routledge, 1999); Julie Soloway, 'Environmental trade barriers in NAFTA: the MMT fuel additives controversy', *Minnesota Journal of Global Trade*, vol. 8, no. 1 (1998); David Vogel and Alan M. Rugman, 'Environmentally related trade disputes between the United States and Canada', *American Review of Canadian Studies* (summer 1997), pp. 271–92.

1 How can a health and safety regulation become a trade barrier? Provide examples.

2 How can different environmental circumstances make one country's regulations inefficient in another country?

3 What are some reasons why the government might not be willing to make allowances for different countries?

REAL CASE

Turkish lira in crisis: record low in 2018

The Turkish economy was performing rather well in 2017 as the nation exceeded forecasted levels of growth. For instance, in the third quarter of 2017 GDP levels were 11.1 per cent higher in comparison with the third quarter of 2016. Moreover, the rate of growth during this period was 5 per cent higher than the three previous quarters and the nation seemed to be on track to generate an impressive 7 per cent growth for the entirety of 2017. This prosperity was reflected in the opening of multiple new shopping centres throughout the country, as consumers seemed to have healthy levels of disposable income. However, this dramatically changed in 2018 and the upbeat mood of consumers within Turkey quickly changed as they found themselves in difficult times amid the start of the 2018 Turkey currency crisis.

The lira, the currency in Turkey, hit a record low in 2018 and created many obstacles for the nation as prices for everyday items increased on a regular basis. Thousands of businesses in Turkey were somewhat involved in foreign currency loans to fund their investments. However, in 2018 the lira lost approximately 40 per cent of its value against other currencies such as the dollar; Figure 4.2 illustrates the currency exchange rate between the US dollar and the Turkish lira.

This depreciation resulted in difficult times for Turkish organisations as it was more expensive to purchase goods and services, or repay debts, that were in foreign currencies such as euros and dollars. Given this, Tayyip Erdogan, the Turkish President, announced in September 2018 that there would be a ban on using foreign currency for a large range of different contracts. This created chaos in many organisations as firms were given a 30-day deadline for converting their existing foreign currency contracts and agreements into Turkish lira. Despite some advantages, for example, tourism increased by 60 per cent due to travellers being able to take advantage of their strong foreign currencies, the situation looked rather bleak for the Turkish nation.

Figure 4.2 **Exchange rate: US dollar against Turkey's lira in 2018**

Source: https://www.tradingview.com/.

There are lessons to learn from Turkey's currency crash, particularly in terms of the way in which many of the economic activities in one country are connected and often dependent on those in other countries. This can be through cross-border supply chains and trade links or the movement of money (inward and outward investment) or people (such as tourists). Experts suggest that there were a number of factors contributing to the decline of the lira. First, investors were concerned that Turkish companies had simply borrowed too much following the construction boom in 2017 and subsequently struggled to repay loans in foreign currencies, as repayments were significantly higher than initially anticipated. Second, the relationship between Turkey and the US was fairly negative. This was partly due to the detainment of American pastor, Andrew Brunson, placed under house arrest in Turkey over terrorism charges, resulting in a bitter dispute between Washington and Ankara. US retaliation, led by Donald Trump, took the form of new trade tariffs, particularly on imports of steel and aluminium from Turkey. Third, and more generally, Erdogan and the government were blamed for poor national economic management. The central bank did not have independence in setting interest rates, which is one economic lever that should not be politically manipulated. In a clear case of political nepotism, Erdogan also put his son-in-law in charge of Turkey's economic policy in 2018.

High levels of foreign currency loans coupled with the political landscape undoubtedly played a vital role in the devaluation of the lira. More recent events, including the release of the detained US pastor, have triggered a rally in the value of the lira, but politics and economics still make for a complex and unstable mix in Turkey.

*Sources:*https://www.bbc.co.uk/news/world-europe-45142256;
https://www.ft.com/content/90479ce0-bb64-11e8-8274-55b72926558f;
https://www.theguardian.com/business/live/2018/aug/17/turkish-lira-volatile-as-us-warns-of-more-sanctions-business-live; https://www.ft.com/content/6c0a6f26-c012-11e8-95b1-d36dfef1b89a.

1 How well was Turkey's economy performing before the lira decreased in value?

2 Why did the depreciation of the lira create problems for businesses in Turkey?

3 What are the reasons why the lira decreased in value?

NOTES

1 Craig S. Smith, 'Workers of the world, invest!' *New York Times*, 19 August 2001, section 3, p. 3.

2 For more on this, see Erik Eckholm, 'Chinese president is optimistic about relations with the US', *New York Times*, 10 August 2001, pp. A1, A8.

3 'Private economy yields 40% of gross product in Shanghai', *People's Daily Online*, 9 March 2005.

4 Paul Starobin and Olga Kravchenko, 'Russia's middle class', *Business Week*, 16 October 2000, pp. 78–84.

5 R. Molz, 'Privatization of government enterprise: the challenge to management', *Management International Review*, vol. 29, no. 4 (1989), pp. 29–30.

6 Ibid., pp. 32–3.

7 https://ec.europa.eu/growth/industry/policy_en

8 https://www.thebalance.com/facts-about-nafta-statistics-and-accomplishments-3306280

9 Larry Reibstein et al., 'A Mexican miracle?' *Newsweek*, 20 May 1991, pp. 42–5; Paul Magnusson et al., 'The Mexico pact: worth the price?' *Business Week*, 27 May 1991, pp. 32–5.

10 https://ustr.gov/trade-agreements/free-trade-agreements/north-american-free-trade-agreement-nafta

11 World Bank, 'Civil Society: History', https://www.worldbank.org/en/about/partners/civil-society#2 (2019); 'Globalization, what on earth is it about?' bbc.co.uk, 14 September 2000.

12 'Who are the Prague protestors?' BBC.co.uk, 26 September 2000.

13 World Bank, ‘Civil society engagement brochure’, https://www.worldbank.org/en/about/partners/civil-society, (2019).

14 http://www.eurodad.org/

15 Alan M. Rugman, *The End of Globalization* (London: Random House, 2001).

16 ‘Mercosur: South America’s Fractious Trade Bloc’ (2018). https://www.cfr.org/backgrounder/mercosur-south-americas-fractious-trade-bloc

BIBLIOGRAPHY

Cuervo-Cazurra, A. 'Corruption in international business', *Journal of World Business*, Vol. 51, No. 1 (2016).

Czinkota, Michael R., Knight, Gary, Liesch, Peter W. and Steen, John. 'Terrorism and international business: a research agenda', *Journal of International Business Studies*, vol. 41 (June/July 2010).

Dahan, Nicolas, Doh, Jonathan P., Oetzel, Jennifer and Yaziji, Michael. 'Corporate-NGO collaboration: creating new business models for developing markets', *Long Range Planning*, vol. 43, no. 2 (2010).

Dunning, John H. (ed.). *Governments, Globalization and International Business* (Oxford: Oxford University Press, 1997).

Flammer, C. 'Does product market competition foster corporate social responsibility? Evidence from trade liberalization', *Strategic Management Journal*, vol. 36, no. 10 (2015).

Fratianni, Michele and Oh, Chang H. 'Expanding RTAs, trade flows, and the multinational enterprise', *Journal of International Business Studies*, vol. 40 (September 2009).

Frynas, J. G. and Stephens, S. 'Political corporate social responsibility: Reviewing theories and setting new agendas', *International Journal of Management Reviews*, vol. 17, no. 4 (2015).

Graham, Edward M. *Fighting the Wrong Enemy: Antiglobal Activists and Multinational Enterprises* (Washington, DC: Institute for International Economics, September 2000).

Henisz, Witold, Mansfield, J., Edward, D. and Von Glinow, Mary Ann. 'Conflict, security, and political risk: international business in

challenging times', *Journal of International Business Studies*, vol. 41 (June/July 2010).

Hoffmann, Volker H., Trautmann, Thomas and Hamprecht, Jens. 'Regulatory uncertainty: a reason to postpone investments? Not necessarily', *Journal of Management Studies*, vol. 46, no. 7 (November 2009).

Jensen, Nathan M, Li, Quan and Rahman, Aminur. 'Understanding corruption and firm responses in cross-national firm-level surveys', *Journal of International Business Studies*, vol. 41 (2010).

Kobrin, Stephen J. 'Sovereignty @ bay: globalization, multinational enterprises, and the international political system', in Alan M. Rugman (ed.), *The Oxford Handbook of International Business*, 2nd ed. (Oxford: Oxford University Press, 2009).

Kolk, Ans. 'Social and sustainability dimensions of regionalization and (semi)globalization', *Multinational Business Review*, vol. 18, no. 1 (2010).

Lee, Seung-Hyun, Oh, Kyeungrae and Eden, Lorraine. 'Why do firms bribe?' *Management International Review*, vol. 50, no. 6 (1 December 2010).

McCarthy, Daniel J., Puffer, Sheila M. and Shekshni, Stanislav Vladimirovich. *Corporate Governance in Russia* (Aldershot: Edward Elgar, 2004).

Muller, Alan and Kolk, Ans. 'Extrinsic and intrinsic drivers of corporate social performance: evidence from foreign and domestic firms in Mexico', *Journal of Management Studies*, vol. 47, no. 1 (2010).

Ostry, Sylvia. 'The multilateral trading system', in Alan M. Rugman and Thomas Brewer (eds.), *The Oxford Handbook of International Business*, 1st ed. (Oxford: Oxford University Press, 2001).

Puffer, Sheila M. and McCarthy, Daniel J. 'The emergence of corporate governance in Russia', *Journal of World Business*, vol. 38, no. 4 (November 2003).

Puffer, Sheila M. and McCarthy, Daniel J. 'Can Russia's state-managed, network capitalism be competitive? Institutional pull versus institutional push', *Journal of World Business*, vol. 42, no. 1 (March 2007).

Rajwani, T. and Liedong, T. A. 'Political activity and firm performance within nonmarket research: A review and international comparative assessment', *Journal of World Business*, vol. 50, no. 22 (2015).

Regnér, Patrick and Edman, Jesper. 'MNE institutional advantage: how subunits shape, transpose and evade host country institutions', *Journal of International Business Studies*, vol. 45, no. 3 (2013).

Rugman, Alan M. (ed.). *Foreign Investment and NAFTA* (Columbia, SC: University of South Carolina Press, 1994).

Rugman, Alan M. 'Toward an Investment Agenda for APEC', *Transnational Corporations* (August 1997).

Rugman, Alan M. (ed.). *North American Economic and Financial Integration* (Oxford: Elsevier, 2004).

Rugman, Alan M. and Doh, Jonathan. *Multinationals and Development* (New Haven, CT: Yale University Press, 2008).

Rugman, Alan M. and Gestrin, Michael. 'The strategic response of multinational enterprises to NAFTA', *Columbia Journal of World Business*, vol. 28, no. 4 (winter 1993).

Rugman, Alan M. and Verbeke, Alain. 'Multinational enterprise and national economic policy', in Peter J. Buckley and Mark Casson (eds.), *Multinational Enterprises in the World Economy: Essays in Honor of John Dunning* (Aldershot: Edward Elgar, 1992).

Rugman, Alan M. and Verbeke, Alain. 'Multinational enterprises and public policy', in Alan M. Rugman (ed.), *The Oxford Handbook of International*

Business, 2nd ed. (Oxford: Oxford University Press, 2009).

Spar, Debora L. *Ruling the Waves: Cycles of Discovery, Chaos and Wealth* (New York: Harcourt, 2001).

Spar, Debora L. 'National policies and domestic politics', in Alan M. Rugman (ed.), *The Oxford Handbook of International Business*, 2nd ed. (Oxford: Oxford University Press, 2009).

Trebilcock, Michae, and Howse, Robert. The *Regulation of International Trade*, 3rd ed. (London: Routledge, 2005).

Chapter 5

INTERNATIONAL CULTURE

Contents

Objectives of the chapter

Places and people differ. The Japanese tend to be very polite, the Australians characteristically blunt. Red means ‘danger’ or ‘stop’ to the British, but in Turkey it signifies death and in China,

good fortune. In France getting into a ***grande école*** tends to guarantee good job prospects whereas in Saudi Arabia the wealth and status of your family is far more important.

Patterns of global diversity and the implications of these differences have been studied from a range of perspectives, by sociologists, psychologists, anthropologists and political scientists. Here we are concerned with how cultural diversity and related differences in the behaviour, norms and expectations of particular groups of employees, managers, colleagues or customers affect management decision making and corporate organisations. After an introduction to the kinds of business contexts in which cultural differences matter, this chapter will describe some typologies of national cultural differences and discuss the implications of these for international managers.

The specific objectives of this chapter are to:

1. *Define* culture and explain the factors that underlie cultural differences.
2. *Show* where and why cultural differences matter to international managers.
3. *Explain* a number of frameworks that help identify important cultural differences.
4. *Examine* how firms can anticipate and cope with cultural differences.

ACTIVE LEARNING CASE

Cultures clash as big pharma gets bigger

A series of international mergers has made Pfizer one of the largest pharmaceutical firms in the world. In the process the firm has had to incorporate, integrate and adapt to a wide range of different national cultures as it has absorbed new acquisitions into its expanding organisation. We start the story with the merger of two firms, Pharmacia AB of Sweden (with operations in Italy) and Upjohn Company of the United States, which went through a steep cultural learning curve over 20 years ago, before being acquired in turn by Pfizer.

Senior managers leading the merger between Pharmacia and Upjohn only came to realise how significant the cultural differences were between Kalamazoo (Michigan, United States), Stockholm (Sweden) and Milan (Italy) after the merger took place in 1995. Everyday local preferences, beliefs and workplace practices underpin differences that can amount to major conflicts if they are not understood and incorporated into merged structures.

Swedes take off most of the month of July for their annual vacation; Italians take off most of August. Not knowing this, US executives scheduled meetings in the summer only to have to cancel many because their European counterparts were at the beach. As the more dominant US firm began to impose its way of doing things on the newly acquired European organisations, international relationships became increasingly strained.

Neither the Swedes nor the Italians were happy with impositions such as the drug and alcohol testing policy brought in by Upjohn, or the office smoking ban. These clashed with local ways of doing things and the more informal work environment that these cultures prefer. Although Upjohn later relaxed many of these work rules, allowing some local practices and preferences to prevail, ill-feeling and a degree of resistance had already developed among European colleagues.

The additional bureaucracy and the command-and-control style imposed by the Americans created more significant problems for the 34,000 employees and managers in Pharmacia and Upjohn Company. The Swedes were used to an open, team-based style of management where responsibilities are devolved; managers are trusted and not strictly monitored or closely managed. Swedish executives also tend to build up a consensus behind big decisions, ‘getting everyone in the

same boat' (*alla aer i baten*) rather than handing orders down the hierarchy. As a traditional US multinational, however, Upjohn was more used to strong leadership and a centralised command-and-control structure. Its CEO, Dr. John Zabriskie, quickly created a strict reporting system, tight budget control, and frequent staffing updates, which clashed with the Swedish organisation style. Swedish managers would leave meetings disgruntled, having been overruled by US executives keen to push their vision of the merged company.

The Swedes' own ways of doing things had already clashed with the Italian style of management, following the takeover of Farmitalia (part of Montedison) by Pharmacia in 1993. Italians are used to a distinctive division between workers (and their strong unions) and managers. Their steeper hierarchies contrast the more egalitarian Swedes. Italians also place a high value on families and will leave work to tend to sick relatives or help with childcare, which the Swedes frown upon. The addition of the Americans from Upjohn to this mix created further cultural confusion. Communication problems, beyond the obvious language differences, became a real barrier to honest dialogue. 'You go there thinking you're going to streamline the place,' said American Mark H. Corrigan, Pharmacia and Upjohn Vice President for Clinical Development, 'and you leave just having added five pounds from some wonderful meals.'

These differences, many of them small but important at the local level, quickly began to have an impact on the overall performance of the merged company. In the months and years following the merger, unforeseen inefficiencies and added costs began to undermine the potential synergies of bringing together two such companies in the first place. At one level the problems amounted to things like cancelled meetings, new organisation demands (such as monthly report writing), and a general decline in staff morale. These and other changes added an estimated $200 million to the predicted costs of the restructuring, taking the total cost to $800 million. Even more seriously, for a pharmaceutical company heavily reliant on its new drugs pipeline to survive, delayed product launches and the loss of key staff (including the head of R&D at Pharmacia) had a longer-term impact. 'There was probably an under-appreciation . . . of these cultural differences,' says Art Atkinson, former Vice President for Clinical Research and Development. Restructuring the firm's global R&D structure, with a new and neutral London-based centre for the R&D function, did not

help. This simply added a layer of management and a more complex matrix reporting structure, which further alienated key R&D personnel.

In 1997, after the stock price of the merged corporation had fallen significantly, CEO John Zabriskie resigned. Swede Jan Ekberg, the former head of Pharmacia, took over temporarily and began to rebuild aspects of the merged organisation. After acquiring a major part of Monsanto in 2000, Pharmacia and Upjohn became Pharmacia, which was then itself acquired by the US giant Pfizer in April 2003 for $60 billion. The aim was to expand the portfolio of consumer health products, stronger oncology products and the Celebrex brand.

Pfizer then undertook a large-scale global restructuring and continued its pattern of acquisitions. In 2009 it bought Wyeth for $68 billion and tried to acquire AstraZeneca for over $100 billion in 2014, but this was blocked on the grounds that it would create a monopoly in certain pharmaceuticals product areas. Then in 2015 it began a process of merging with Allergan (a £160 billion acquisition) to create the largest pharmaceuticals firm in the world with annual revenues of $64 billion. This created huge controversy because a major objective was to structure this with the smaller, Dublin-based Allergan buying Pfizer. This would both avoid competition policy restrictions and enable Pfizer to cut its tax bill by moving its registered HQ from the US to Ireland. This created a great deal of negative press for the firm, with the chair of a UK Parliamentary committee in 2015 calling it a 'shark that needs feeding' because of its style of aggressive acquisitions.

In 2018, Pfizer announced it would merge its consumer healthcare unit with GlaxoSmithKline (GSK). The combined divisions would have annual sales of almost $13 billion, making them the new market leader. GSK is a UK pharmaceutical firm and its healthcare division is perhaps best known for brands such as Aquafresh toothpaste, Panadol and Beechams cold and flu remedies. Reports suggest that GSK will control 68 per cent of the division, whereas Pfizer would control the remaining 32 per cent. GSK and Pfizer have stated that with the combination of both consumer healthcare businesses will create substantial further value for their shareholders. Although GSK have announced that there will be job losses, the merger will pay off soon and predict cost savings of around $750 million by 2022.

Looking back, it is debatable as to whether the lessons of the earlier mergers and integrations were learned. Cultural clashes still have a significant impact when firms try to integrate their organisations to create the kinds of strategic synergies that are clear on paper. There are strong signs, however, that Pfizer has focused in recent years on developing a strong corporate culture, partly to deal with this issue. HR training and internal communications under CEO Ian Read emphasise 'ownership' and 'straight talk' (http://pfizercareers.com). Employees are known as 'colleagues' and the firm has established a network of more than 100 'local, site-based Colleague Resource Groups (CRGs) affiliated with a variety of diverse communities'. Depending on your perspective, this could mean their intention is to harmonise and integrate different national and corporate cultures as Pfizer progresses through each merger – or suppress differences and incorporate new cultures into its Anglo-American style of management.

Source: R. Frank and T. M. Burton, 'Pharmacia & Upjohn faces culture clash: Europeans chafe under US rules', *Wall Street Journal*, 4 February 1997; R. J. Thomas, 'Irreconcilable differences', *Accenture Outlook*, vol. 1 (2000); Pfizer, *Annual Report*, 2003; Ransdell Pierson and Bill Berkrot, 'Pfizer to buy Allergan in $160 billion deal*', Reuters,* 24 November 2015; Steve Brozak, 'No longer king of the north, Pfizer looks to recapture crown', *Forbes*, 30 April 2014; Sarah Gordon, 'Honesty and quelling culture clash are vital for successful mergers', *Financial Times*, 29 July 2015. 'MPs grill Pfizer and Vince Cable over AstraZeneca offer', *Telegraph,* 12 May 2014; https://news.sky.com/story/glaxosmithkline-and-pfizer-agree-10bn-healthcare-merger-11585641; *New York Times* (2018) 'GlaxoSmithKline and Pfizer to Merge Consumer Health Units', https://www.nytimes.com/2018/12/19/business/gsk-pfizer-consumer-healthcare.html.

1. **What kinds of cultural differences matter when organisations from different countries merge?**
2. **How well do the characteristics described in the case match the respective, stereotypical national cultures of these countries?**
3. **What could senior managers do before and after mergers to alleviate some of the problems that result from culture clash?**

4 **Explain why one organisation might want to impose some of its ways of doing things on another, such as an acquired firm or subsidiary.**

INTRODUCTION

The number of workers employed by foreign-owned companies has grown significantly over the past 20 years as a result of the expanding activities of foreign affiliates of MNEs around the world. For many people, both employers and employees, this has brought home the realities of globalisation. An estimated 74 million people globally now work for foreign companies, a three-fold increase since the 1990s, but a number that has stabilised in recent years. Companies such as General Motors, British Petroleum and General Electric are among the largest private sector employers in economies such as Malaysia and Singapore.[1]

This growing multicultural workforce, part of the increasingly global patterns of exchange and interaction discussed earlier in this book, makes it more and more important to understand how people's preferences, beliefs and values differ. Understanding international cultural differences allows us to be aware of and adapt to the differences that matter for managers.

WHAT IS CULTURE?

Culture can be defined as 'the sum total of the beliefs, rules, techniques, institutions, and artefacts that characterise human populations'[2] or 'the collective programming of the mind'.[3]

Sociologists generally talk about the **socialisation** process, referring to the influence of parents, friends, education and the interaction with other members of a particular society as the basis for one's culture. These influences result in learned patterns of behaviour common to members of a given society.

As you can see, definitions of culture vary according to the focus of interest, the unit of analysis and the disciplinary approach (psychology, anthropology, sociology, geography, etc.). This is significant in that studies of cultural differences adopt a specific definition and set of measurable criteria, which are always debatable. Research into culture and its impact in business and management studies is highly contentious and should not just be taken at face value, including the studies described below.

There is a strong consensus, however, that key elements of culture include language, religion, values, attitudes, customs and norms of a group or society. A very wide range of books and articles have examined differences across these dimensions, in some cases reducing (in a reductionist sense) complex and nuanced behaviour into simple categories, such as 'tight and loose' cultures or 'rule makers and rule breakers'.[4] Table 5.1 shows how the world's population is divided according to geography, language and religion.

Language is perhaps the most important key to understanding culture in general and the specific values, beliefs, attitudes and opinions of a particular

individual or group. English is widely accepted as the language of business; many global institutions and companies have adopted English as their official language. For many firms, such as Toyota, NEC, Hitachi and IBM Japan, English-speaking ability is a prerequisite for promotion.[5] However, any assumption that speaking the same language removes cultural differences is dangerous – it normally just hides them. Moreover, a reliance on English by British and American managers, and a lack of other language skills, can weaken their ability to empathise with and adapt to other cultures.

Religion, linked to both regional characteristics and language, also influences business culture through a set of shared core values. Protestants hold strong beliefs about the value of delayed gratification, saving and investment. The sociologist Max Weber, writing in 1904, saw this Protestant work ethic as the 'spirit of capitalism' during the Industrial Revolution.[6] Rather than spending, consuming and enjoying life now, their religious beliefs prompted the Protestants to look to longer-term rewards (including those in the after-life). There are parallels with the Confucian and Shinto work ethics, which also view spiritual rewards as tied to hard work and commitment to the fruits of industry. Contrasting this, a more stoic attitude among some African populations partly explains their acceptance of the ways things are, because it is the 'will of God' (*shauri ya Mungu*).

Table 5.1 World population percentages in terms of home region, language and religion

Home region	%	Language	%	Religion	%
Asia	60	Chinese	19.2	Christianity	33
Africa	16	Spanish	6.5	Islam	24
Europe	10	English	5.6	Non-religious	16
North America	8	Arabic	4.6	Hinduism	16
South America	5	Hindi	3.8	Buddhism	7
Oceania	1	Bengali	3.6	Other	4
		Portuguese	3.3		
		Russian	2.3		
		Japanese	1.9		
		Lahnda	1.8		
		Other	47.5		

Source: www.nationsonline.org; http://www.pewforum.org/2012/12/18/global-religious-landscape-exec/ religion based on 2012 figures; Chinese includes all variants https://www.ethnologue.com/statistics/size; World population based on 2016 data.

At the most general level, culture can refer simply to the lifestyle and behaviour of a given group of people, so **corporate culture** is a term used to characterise how the managers and employees of particular companies tend to behave. But the term is also used by human resource managers and senior management in their attempts to proactively shape the kind of behaviour (innovative, open, dynamic, etc.) they hope to nurture in their organisations. Promoting a distinctive corporate culture is also expected to enhance the sense of community and shared identity that underpins effective organisations.

THE IMPORTANCE OF CULTURE IN DIFFERENT BUSINESS CONTEXTS

Cross-cultural management issues arise in a range of business contexts. *Within* individual firms, for example, managers from a foreign parent company need to understand that local employees from the host country may require different organisation structures and HRM procedures. In cross-border mergers and acquisitions (M&As), realising the expected synergies very often depends on establishing structures and procedures that encompass both cultures in a balanced way. Cross-border joint ventures, alliances or buyer–supplier relationships *between* two or more firms also require a cultural compromise. Finally, for firms to sell successfully to foreign customers requires culturally sensitive adaptations to products, services, marketing and advertising.

Figure 5.1 outlines, at the most general level, links between business contexts and particular characteristics of individuals or groups that are influenced by social and cultural norms of a particular region. At the face-to-face level in meetings, the language and behaviour of different peoples vary and their mutual understanding of each other's culture will influence the effectiveness and efficiency of communication between them. This influences how well multicultural workplaces operate at all levels, from strategy setting at the senior level to plant-floor operations.

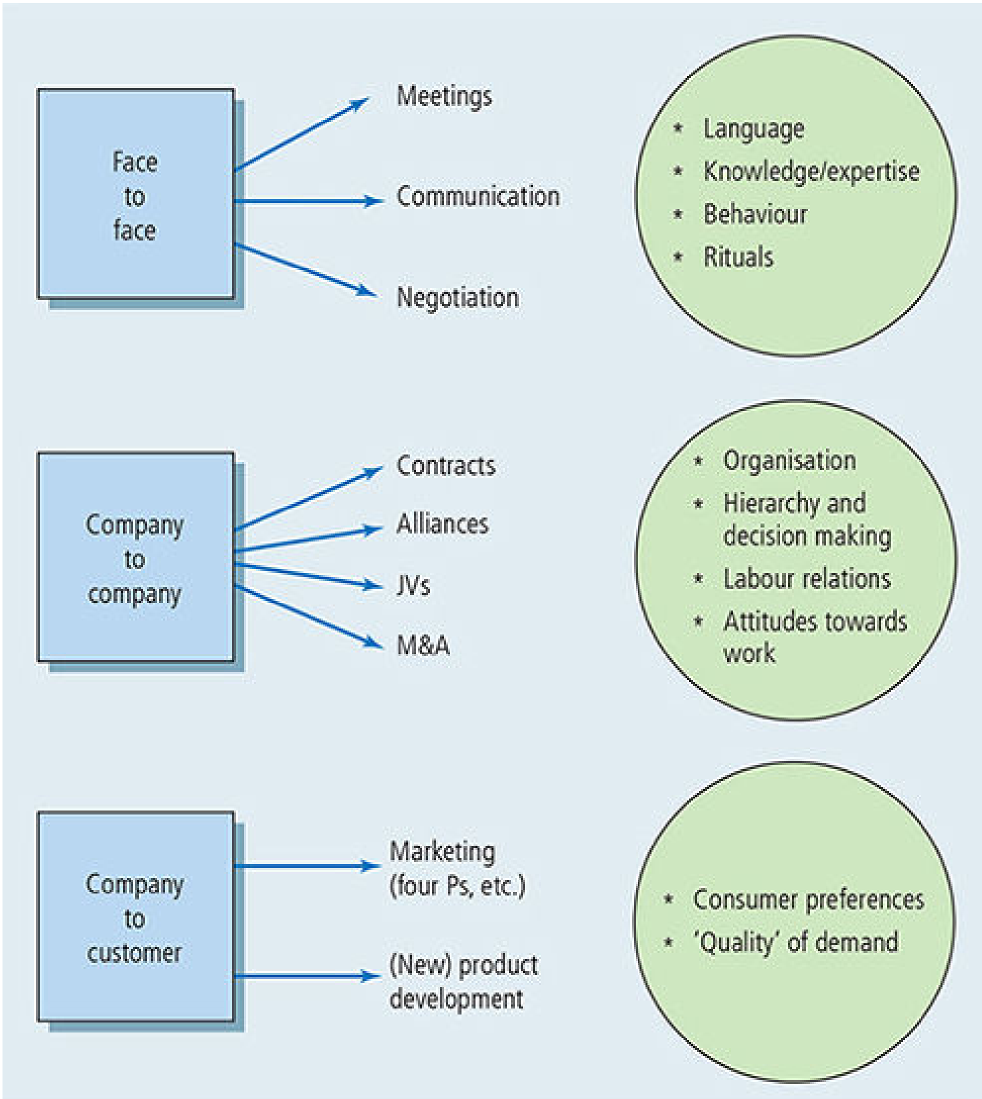

Figure 5.1 Cross-cultural business contexts

Firms also tend to have different organisational and decision-making practices depending on where they have evolved and which cultures and subcultures they encompass. For firms to build successful alliances and partnerships, or for M&A activities to succeed at the company-to-company level, there needs to be an understanding of the organisational differences between them. This covers practically every element of corporate organisations from decision-making structures and systems and

management–labour relationships to individual employees' attitudes towards their work and their employer.

Finally, culture influences the behaviour and preferences of clients and customers. To sell successfully in a foreign market, a manager needs to adapt his or her product or service to meet the different needs of that particular group of customers. Any alteration in advertising, marketing, product or service features, after-sales support, technical back-up, documentation, etc., will be partly guided by cultural differences.

Failure to do this ends in the kinds of marketing mistakes and communication blunders that become marketing folklore. For example, Ford's low-cost truck was initially marketed as the Feira to Spanish-speaking people, but this means 'ugly old woman' in Spanish. The Ford Comet, a high-end car, was sold as the Caliente in Mexico, which is local slang for 'prostitute'. Unsurprisingly, neither model did well in these markets. This reinforces the above point about the importance of language, but also demonstrates how some of the largest and most experienced companies do not appear to do the most basic cultural due diligence (their homework!) when launching products and services in foreign markets. Chapter 12 on marketing strategy examines these kinds of issues more closely.

Across all of the business contexts in Figure 5.1, ignorance of cultural differences represents a common stumbling block for international managers. **Ethnocentrism**, the belief that one's own way of doing things is superior to that of others, can also be a major barrier to good international management. The challenge lies in recognising differences, combining the advantages that stem from different styles and approaches, adjusting and adapting to succeed with different people, in different partnerships and in different markets.

Active learning check

Review your answer to Active Learning Case question 1 and make any changes you like. Then compare your answer to the one below.

1 What kinds of cultural differences matter when organisations from different countries merge?

The definition of culture itself gives some indicators of the kinds of differences that matter. Organisations from different countries will have developed different beliefs, values and patterns of behaviour based on their underlying national culture. A wide range of differences could be important, including attitudes towards work and workplace practices, management–labour relations, the decision-making hierarchy and division of responsibilities. Cross-border M&A often also requires changes to the marketing and branding of products and services as sales are expanded into new markets. Differences in the language, values and preferences of customers in different countries also need to be taken into account.

Culture has always been important

Despite the various patterns and processes of globalisation, cultural differences still remain important. Even with greater common access, via various media and the internet, to the same brands, rock icons and sports stars, differences remain. Terms like **cultural convergence** or, simply, Americanisation (the homogenisation of global consumer preferences through the ubiquity of McDonald's, Coca-Cola and Ford) overstate the similarities between groups of people around the world. (See the case **International Business Strategy in Action: McDonald's**.)

INTERNATIONAL BUSINESS STRATEGY IN ACTION

McDonald’s

When José Bové, a self-proclaimed leader of France’s anti-globalisation movement, was sentenced for vandalising a McDonald’s restaurant in 1999, he claimed to have the backing of the French people. That might have been an overstatement, but 40,000 French people were there to show their support. It was not only the French, however; in the 1990s McDonald’s restaurants were vandalised in about 50 countries. At issue is the worldwide perception that McDonald’s represents a particular friendly Ronald-McDonald type of US imperialism. Traditional lifestyles, critics say, are being eroded by McDonald’s marketing practices, its value chain system, its fast-food concept and the unhealthy food itself.

Yet, McDonald’s bends over backward to blend into local cultures. The company advertises itself to its critics as a global company owned and run by local people. Indeed, the franchise system makes it so that McDonald’s Japan is run by the Japanese and Israel’s McDonald’s restaurants are run by Israelis. Local business owners choose their menu’s offerings to fit their culture, find alternative suppliers and create suitable marketing for their culture. An American in Saudi Arabia might seat single men with families at a McDonald’s opening, but a Saudi Arabian owner would know that this is unacceptable and the restaurant will be designed to accommodate the culture.

In the land of José Bové, Asterix, a French comic-strip character who stands for individuality and ironically symbolises local resistance to imperial forces, replaced the goofy Ronald McDonald in the company’s marketing in the early 2000s. In 1999, French McDonald’s went the extra mile to prove how local it was by printing advertisements making fun of US eating habits. In one ad, a large American cowboy complains that McDonald’s France does not import American beef to ‘guarantee maximum hygienic conditions’. French restaurants are more fashionably and more comfortably designed than North American ones to create an environment where customers may enjoy longer meals in accordance with French tradition. If they want, customers can order a beer from the menu.

In India, where local tastes are very different from those in the United States, the company crafted an entirely different menu that does not use beef or pork due to the mostly vegetarian

population. The Indian Big Mac is made of lamb. In Israel, the locally owned McDonald's purchases over 80 per cent of its ingredients from local producers, including 100 per cent kosher hamburger meat, potatoes, lettuce, buns and milkshake mix. There are no cheeseburgers in Israel's McDonald's because dairy products cannot be eaten together with meat.

On the other hand, McDonald's does bring its own culture to its foreign operations. In China, where children's birthdays are not traditionally celebrated, a successful McDonald's marketing strategy encouraged birthday parties at their establishments – not a bad deal for children, but still a cultural effect from a foreign multinational. More mundane things, such as combo meals, are popularised through McDonald's expansion. By promoting its carbonated beverages in India, the firm is unsettling the country's tea culture. The company's presence creates a cultural exchange, not a one-sided cultural takeover.

Beyond reactionary behaviour against McDonald's cultural 'impositions', McDonald's has had to suffer simply for being born in the United States. Just hours after the United States began bombing Afghanistan in 2001 McDonald's restaurants were vandalised in cities in Pakistan and Indonesia and Muslim clerics asked for the boycott of US products.

For activists and cultural protectors, the most frustrating thing is that their calls go unheeded. Owners of McDonald's franchises continuously remind customers that they too are locals, that their employees are locals, and that their suppliers are mainly local. In Brazil, some anti-war protestors on their way home will stop at a McDonald's for a bite to eat.

Some of McDonald's major troubles, however, are in its most established markets in the United States, Canada and the UK. Russian and Chinese go-getters might think that a meal in McDonald's puts them in a class above, but in its two major markets of North America and Europe, where the firm derives over two-thirds of all revenue, the food is considered unhealthy. Indeed, both Canada and the UK considered imposing a tax on fatty foods on the grounds that it was damaging to people's health and it costs the healthcare system a substantial amount. The tax is unlikely to be imposed because of a strong backlash from poverty groups which argue that this tax would place an uneven burden on those who depend on cheap food for their everyday survival. In the United States, the firm is being sued over claims that it misled parents about the nutritional value of its products, leading their children to become obese and unhealthy. McDonald's in the UK reacted by

eliminating supersized options from the menu. A set of healthier options has now been introduced in Europe and North America as the company fends off critics in some of its friendliest markets. The company has also embraced sustainability and extended its corporate social responsibility (CSR) activities and reporting in order to keep one step ahead of a wider set of critics. In 2011, McDonald's was among Fortune's top ten world's most admired companies and as of 2018 it remained among the top 50. Its recent decline in rating has been argued to be down to recent consumer criticism concerning menu offerings in accordance with recent protests over minimum wages offered to workers. Furthermore, the organisation received criticism in 2017, as McDonald's France were taken to task by Zero Waste France (ZWF) due to concerns about recycling and waste management methods. However, in this same year, McDonald's announced its intention to double its outlet footprint in China by 2022. With this in mind, the organisation revealed in 2018 that over 95 per cent (1,800 restaurants) of the new openings in China would fulfil the Leadership in Energy and Environmental Design (LEED) accreditation issued by the US Green Building Council. Furthermore, the fast food giant announced that it intends to source 100 per cent of its packaging from renewable, recycled or certified sources by 2025. Arguably, this is in a hope to reinforce consumers' confidence and trust with the giant's commitment to sustainable growth.

What makes McDonald's such an admired, recognisable brand, even amid an enduring fast-food backlash? New items on the menu have helped: salads (with Newman's Own low-fat dressing), wraps, oatmeal and apple dippers. In addition, the chain constantly adds to its dollar menu, catering to those who have felt the recession's crunch. McDonald's also operates a wide range of charity programmes, including teacher awards and youth basketball games. And financially, the company has been reported to be doing fine. As of 2017, McDonald's operates in 121 countries with over 37,000 outlets which serve approximately 68 million customers on a daily basis. In 2017, McDonald's acquired sales of approximately $23 billion and as of 2014 it employed a workforce of 235,000.

Source: David Barboza, 'When golden arches are too red, white and blue', *New York Times*, 14 October 2001; Tony Karon, 'Adieu, Ronald McDonald', *Time*, 24 January 2002; Simon Romero, 'War and abuse do little to harm US brands', *New York Times*, 9 May 2004; McDonald's corporate

website: http://www.aboutmcdonalds.com/mcd/csr/report.html, downloaded June 2011; 'The world's most admired companies', *Forbes*, 2011; http://money.cnn.com/magazines/fortune/mostadmired/2011/; http://fortune.com/worlds-most-admired-companies/mcdonalds-46/; McDonald's, Annual Report, 2014; Corilyn Shropshire, 'McDonald's plunges on Fortune's list of most admired companies', *Chicago Tribune*, accessed from http://www.chicagotribune.com/business/ct-fortune-most-admired-0220-biz-2-20150219-story.html; https://www.verdictfoodservice.com/comment/mcdonalds-takes-lead-environmental-responsibility-qsr/; https://resource.co/article/mcdonald-s-recycling-and-waste-management-insufficient-says-french-report-11870; http://www.annualreports.com/HostedData/AnnualReports/PDF/NYSE_MCD_2017.pdf.

Cultures vary and these variations lead to real and significant differences in the ways that companies operate and people work. Moreover, *because* of globalisation more and more firms are coming head to head with the added complexity of doing business globally, which stems from the huge amount of variety in the world that still exists (and arguably will always exist).

Before moving on to examine some typologies of global cultures, here is a word of warning. Much of this section will describe how various kinds of individual and group behaviour can be linked to specific cultural groups and associate these cultural dispositions with different business styles and company structures. Acting on the basis of cultural stereotypes is highly sensitive and can be problematic. For example, at the simplest level a banker may be able to prove empirically that Pakistanis are more successful than Jamaicans at starting and running small businesses around the world. Using this insight as the basis for discriminating against Jamaicans wanting bank loans for business start-ups is not only unethical, but in most countries falls foul of race discrimination laws.

NATIONAL STEREOTYPES AND KEY - DIMENSIONS OF CULTURE

Culture at two levels

There are traditionally two different approaches to looking at culture:

- The psychic or psychological level, which focuses on the internalised norms, attitudes and behaviour of individuals from a particular culture (**psychic distance** is a measure of differences between groups).
- The institutional level, which looks at national (or group) culture *embodied* in institutions (government, education and economic institutions as well as in business organisations).

In this chapter we will mainly discuss the first, culture as shared psychology, with a brief reference to national institutional differences at the end.

People who are born in, or grew up in, the same country tend to share similar cultural characteristics. Nordström and Vahlne examined a sample of Swedish firms to understand the effects of psychic distance on market-entry strategies and costs.[7] They ranked 20 particular countries according to a range of national characteristics that contribute to psychic distance and found, as you might expect, that Denmark is closest to Sweden (1/20), the UK comes in at 6/20, Portugal at 15/20, Japan 16/20, Brazil 17/20 and Australia 20/20.

Nationality and culture tend to coincide, although nations encompass a wide variety of institutions, religions, beliefs and patterns of behaviour, and distinctive subcultures can always be found within individual countries. The

only way to make sense of this wide diversity is to characterise distinct cultural groups through simplified national stereotypes.

Many studies have attempted to create these stereotypes by mapping and comparing the shared characteristics of managers and employees in different countries.[8] Researchers then examine the effects of key differences on business behaviour, organisation, structure and ultimately the performance of companies from different countries. The following describes the milestone studies of this kind in the management field.

Hofstede's four dimensions of culture

Geert Hofstede is a Dutch psychologist who conducted one of the earliest and best-known cultural studies in management, on IBM's operations in 70 countries around the world.[9] Getting answers to 32 statements from over 116,000 questionnaires, he mapped key cultural characteristics of these countries according to four value dimensions:

1. **Power distance** is the extent to which a culture accepts that power in organisations is distributed unequally. High power distance equates with steep organisational hierarchies, with more autocratic leadership and less employee participation in decision making (see Figure 5.2 for examples).
2. **Uncertainty avoidance** is the degree to which members of a society feel uncomfortable with risk and uncertainty. High uncertainty avoidance (Japan, Argentina, France) will be reflected in the high priority placed on rituals, routines and procedures in organisations and society in general. Countries with low uncertainty avoidance (Denmark, UK, India, US) tend to emphasise flexibility and informality rather than bureaucracy.

3 **Individualism** is the extent to which people are supposed to take care of themselves and be emotionally independent from others (see Figure 5.2 for examples).

4 **Masculinity** is the value attributed to achievement, assertiveness and material success (Japan, Mexico, Germany, UK) as opposed to the stereotypical feminine values of relationships, modesty, caring and the quality of life (Sweden, Netherlands, Denmark), according to Hofstede.

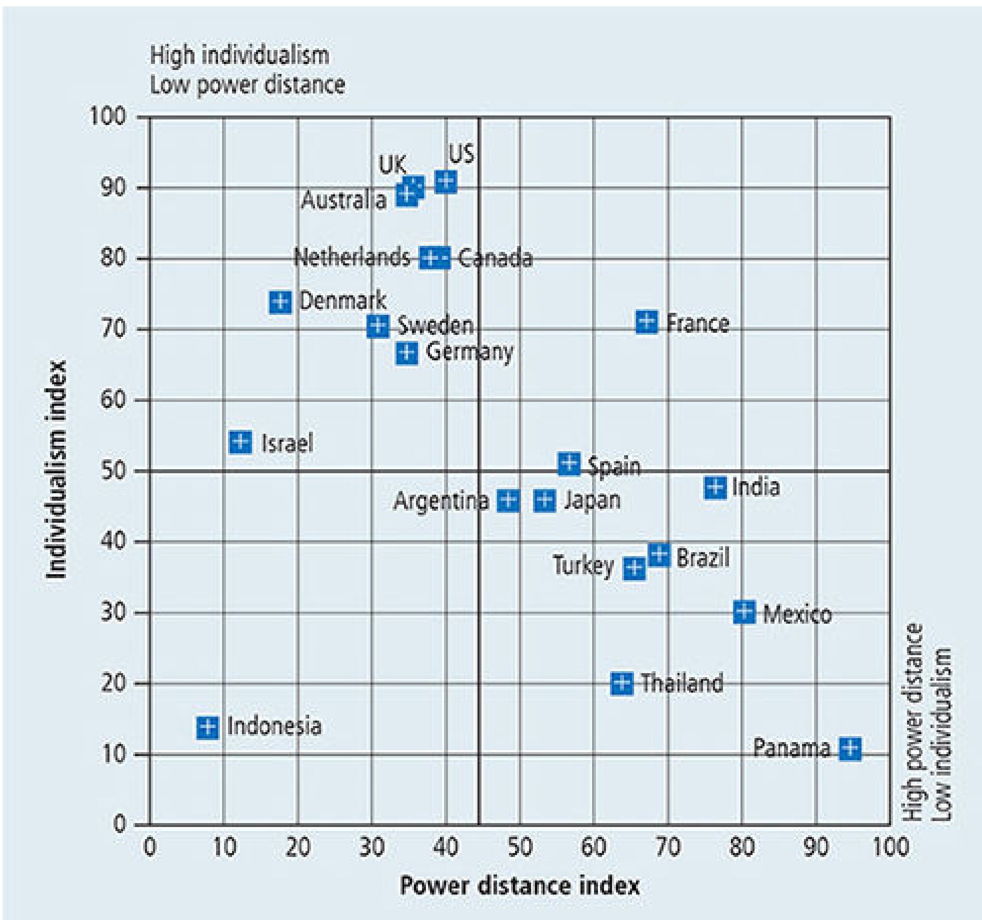

Figure 5.2 **Hofstede's power distance against individualism for 20 countries**

Source: G. Hofstede, 'The cultural relativity of organizational practices and theories', *Journal of International Business Studies* (fall 1983), p. 92. Copyright © Geert Hofstede.

Figure 5.2 illustrates some of Hofstede's findings using two of the most useful dimensions, power distance against the degree of

individualism/collectivism. It reflects some general stereotypes of the countries included, with clear grouping of Australia, the UK and the United States as highly individualistic and less hierarchical (small power distance) cultures against Mexico, Thailand and Panama at the other extreme. We will elaborate on these definitions and their practical interpretation throughout this chapter.

Among his most important contributions, Hofstede provided strong evidence for the significance of national culture over professional role, gender or race, as a determinant of variation in employees' attitudes, values and behaviours, accounting for 50 per cent of the differences his study observed. However, his studies have come in for significant criticism, despite widespread adoption of the four-dimensional framework. Three common criticisms are: (1) that the dimensions developed from data collected between 1968 and 1973 were relevant only for that particular period; (2) that corporate cultural and other influences from this one-organisation study (of IBM) created significant bias; (3) that the sole use of attitude-survey questionnaires was not a valid basis for the resulting values and dimensions his study concluded with.[10]

Although Hofstede has continued to write on culture, organisations and management,[11] it is useful to look more deeply into the work of another well-known Dutch culture guru.

Trompenaars' seven dimensions of culture

Fons Trompenaars built on Hofstede's work by expanding the framework for stereotyping and comparing different national cultures and by focusing more on the management implications of cultural differences. Using initial research involving 15,000 employees in 50 countries, Trompenaars explored the 'cultural extremes and the incomprehension that can arise when doing

business across cultures', even when people are working for the same company.[12]

Trompenaars arrived at seven distinctive dimensions of culture and used the questionnaire responses in his study to map a wide variety of countries along a continuum from one extreme to the other within each dimension. The key to understanding this mapping approach is to identify where each country or culture is positioned *relative* to others on one or more of these dimensions.

Relative positioning gives insights into the kinds of conflicts, misunderstandings and organisational and management problems that are likely to arise when individuals, groups or firms from these countries interact in any of the ways described above.

1 **Universalism** *versus* **particularism**. In universalistic cultures, rules and regulations are applied in all situations, regardless of particular conditions or circumstances. The example used by Trompenaars refers to a salesman who does not fulfil his monthly sales quota because he was looking after his sick son. Should he be penalised according to standard company regulations or should he be excused because of the particular circumstances?

According to Trompenaars' findings, Switzerland, Canada and the United States are among the most universalist. Australia and the UK are also towards this end of the scale. Germany is closer to the centre, as is France, but the latter sits on the particularist side of the scale. Korea, Russia and China are the most particularist of countries. (Note that some of the countries studied by Hofstede, like the strongly particularist Yugoslavia, no longer exist.)

2 *Individualism versus* **collectivism**. This dimension, clearly building on Hofstede, centres on whether individual rights and values are dominant

or subordinate to those of the collective society.

The most individualist countries are Canada, the United States, Switzerland and the UK. Among the most collectivist are Japan, Egypt and India (and Nepal and Kuwait).

3 **Neutral** *versus* **emotional**. This reflects how much emotions are displayed in the workplace. More importantly, it indicates whether emotional or subjective (rather than objective) forms of assessment are thought to be the basis for good decision making in organisations. Some organisations emphasise reports, data and analytical decision making by managers, whereas others feel that opinions, intuition and gut feelings are credible or valid criteria. Predictably the most emotional countries include Italy and France and the least emotional groups (in the workplace at least) are the Japanese, Germans, Swiss, Chinese and Indonesians.

4 **Specific** versus **diffuse**. Do work relationships (such as the hierarchical relationship between a senior manager and a subordinate) exist just in the workplace (are they specific), or do they extend into the social context outside the workplace (diffuse)? Here a telling example is whether an employee is willing to help paint a senior manager's house over a weekend. Clearly Australian bosses are likely to get a characteristically blunt answer to this request! China, Japan, India and Singapore display highly diffuse relationships, Australia and the Netherlands the most specific.

5 **Achievement** *versus* **ascription**. This dimension refers to one's status within organisations, contrasting those cultures where status, credibility, authority and ultimately power tend to be based on merit (achieved) against those where class, gender, education or age tend to be the defining characteristics (status is ascribed).

Countries where status tends to be ascribed include Egypt, Turkey and Argentina (and slightly less so, Russia, Japan and France), and those where it is achieved include Norway, Sweden, and predictably the United States, Australia, Canada and the UK.

6 *Attitudes towards time.* **Sequential** (time as a sequence of events) versus **synchronic** (several events juggled at the same time) views of time tend to relate to punctuality for meetings and deadlines. Swedes and other northern European cultures tend to be punctual and plan according to specific timetables. Many southern European, Latin American and Arabic cultures see punctuality and chronological precision as far less important. They also tend to naturally cope with a range of issues simultaneously, rather than one by one.

7 *Attitudes towards the environment.* This dimension reflects the emphasis a particular culture places on people's relationship with nature and the natural environment. On the one hand some cultures emphasise control and subjugation of environmental forces, whereas others emphasise the need to work with nature, in harmony with the environment. Clearly religious and philosophical differences around the world influence differences within this dimension.

Trompenaars' seven dimensions have been used in a variety of ways to gain insights into the kinds of problems that might arise in the contexts (face to face, company to company, and company to customer) outlined in Figure 5.1. In general they indicate the organisational characteristics we can expect from firms based in particular countries or dominated by certain nationalities. They are also used to measure changes in cultural values and behaviour over time. Research shows that in both Japan and China, for example, achievement orientation is on the increase alongside some elements of individualism.[13]

The Japanese are moving away from a reliance on collectivism in the form of the state, large firms and group associations, and placing more value on personal responsibility and individual performance. In China there is a shift in companies towards performance-related rewards and individual initiative, built on the changing views of the growing urban elite. But there are also wider concerns regarding the social costs as well as the benefits of self-interest.

The GLOBE project's nine dimensions of culture

More recent research has built on the Hofstede and Trompenaars research. The Global Leadership and Organizational Behavior Effectiveness (GLOBE) project began in 1992 and continues today. It has involved 150 researchers collecting data on cultural values and management and leadership attributes from 18,000 managers across 62 countries in the telecommunications, food and banking industries.[14] A 2014 study involving more than 70 researchers collected data from over 100 CEOs and 5,000 senior executives in corporations in a variety of industries in 24 countries and a 2020 study is underway.[15]

In the same way as Hofstede and Trompenaars before them, the researchers place countries along a standard 1 to 7 scale. The GLOBE project, however, ends up with nine key cultural dimensions:

1. *Assertiveness.* The United States, Austria, Germany and Greece are high; Sweden, Japan and New Zealand are low.
2. *Future orientation.* A propensity for planning, investing and delayed gratification: Singapore, Switzerland and the Netherlands are high; Russia, Argentina and Italy are low.
3. *Gender differentiation.* The degree to which gender role differences are maximised: South Korea, Egypt, India and China are high; Hungary,

Poland and Denmark are low.

4 *Uncertainty avoidance.* A reliance on societal norms and procedures to improve predictability, and a preference for order, structure and formality: Sweden, Switzerland and Germany are high; Russia, Bolivia and Greece are low.

5 *Power distance.* Russia, Thailand and Spain are high; Denmark, the Netherlands and Israel are low.

6 *Institutional collectivism (individualism vs. collectivism).* Promoting active participation in social institutions: Sweden, South Korea and Japan are high; Greece, Argentina and Italy are low.

7 *In-group/family collectivism.* A pride in small-group membership, family, close friends, etc.: Iran, India and China are high; Denmark, Sweden and New Zealand are low.

8 *Performance orientation (much like achievement orientation).* Singapore, Hong Kong and the United States are high; Russia, Argentina and Italy are low.

9 **Humane orientation**. An emphasis on fairness, altruism and generosity: Ireland, Malaysia and Egypt are high; Germany, Spain, France, Singapore and Brazil are low.

As you can see, many of these dimensions match those of Hofstede and Trompenaars, and the overall GLOBE framework is very much an extension of their approach.

The GLOBE researchers have examined the HRM implications of these cultural differences for practising managers and looked at ways to avoid the pitfalls of ignorance and insensitivity.[16] A similar long-running study by the CRANET network has focused on European cultural differences and reports similar findings.[17]

As with the other cultural mapping studies by Hofstede and Trompenaars, GLOBE has faced some critical appraisal, which helps us understand the strengths and weaknesses of its concluding framework. A recent set of debates has usefully raised some methodological issues associated with these kinds of studies, and provides interesting points of contention we should be aware of, rather than blindly accepting the above kind of research.[18]

Applying the national culture frameworks

Different styles of communication and interaction result from the cultural differences listed above. These can lead to workplace misunderstandings, poor interpersonal and intergroup relationships, inefficiency and higher costs. Three examples provide some insights into how we can apply the above typologies.

US managers, according to all of the above studies, are highly assertive and performance oriented relative to managers from other parts of the world (they come around the mid-point on all the other dimensions). Their interaction style is characteristically direct and explicit. They tend to use facts, figures and logic to link specific steps to measurable outcomes, and this is the main focus of workplace interaction. Greeks and Russians are less individualistic, less performance oriented and show lower levels of uncertainty avoidance (are less driven by procedures) than the Americans. When Russian and Greek managers, employees, customers, suppliers or public sector officials interact with US counterparts, they may well find their approach too direct and results focused. For them communication is likely to be more about mutual learning and an exploration of relevant issues than an explicit agreement about specific expectations and end results. Similarly, the Swedes may find the US style too aggressive and unfriendly, working against the relationship-building process that for them is a major objective of workplace interaction.

The Koreans and Japanese have highly gender-differentiated societies with males tending to dominate decision making and leading most face-to-face communication. The agenda for discussion is likely set by males, and traditional language forms differ according to whether a man is addressing a woman or an older person talking to a younger person, and vice versa. Gender- (and age-) related roles, responsibilities and behaviours are therefore deeply embedded in language and customs.[19] Poland and Denmark lie at the other end of the continuum on the gender-differentiation dimension. Perhaps even more than other Western managers, their lack of awareness of this cultural difference runs the risk of both embarrassing female employees and offending and alienating senior Japanese male managers. This kind of clash can make negotiations and interaction of all kinds between these groups that much more difficult.

Certain kinds of HRM techniques are inappropriate for organisations that show high power distance ratings. Companies and management consultancies in the UK, the United States and northern European countries have developed fairly participative management systems to improve productivity, based on their characteristically low power distance and flat organisational hierarchies. Techniques such as 360-degree feedback systems for developing management–employee relationships are not likely to work, however, in Mexican, Panamanian, Thai or Russian organisations, which have high power distance and steep hierarchies. Subordinates are uncomfortable being asked to evaluate senior managers, and managers would not see subordinates as qualified to comment on their performance. More than this, to employees in some countries this kind of consultation can give the impression that senior managers do not know what they are doing. The employees may lose faith in senior management's ability and leave!

None of the above examples means that international managers should (or ever could) entirely change their behaviour to suit local values and practices.

Like many of the challenges facing managers, cultural sensitivity and cross-cultural effectiveness come from striking a balance between one's own norms, values and principles and those of the 'foreigner'. The lesson for multinational firms is that ethnocentric corporate cultures and completely standardised HR systems do not work. The key challenge is to adapt to get the best from local differences.

Active learning check

Review your answer to Active Learning Case question 2 and make any changes you like. Then compare your answer to the one below.

2 How well do the characteristics described in the case match the respective, stereotypical national cultures of these countries?

According to the above frameworks they match reasonably well. The US culture is characterised as individualistic, achievement/performance oriented and assertive. Most of these traits clash with the 'feminine' (in Hofstede's characterisation) values of relationships, modesty, caring and the quality of life emphasised by the Swedes. Hofstede finds US managers less hierarchical than most cultures, which is not indicated in either Upjohn or Pfizer. However, as Figure 5.2 shows, both Sweden and the United States have a low power distance and high individualism rating, relative to other countries, but the latter has a slightly higher power distance (steeper management hierarchy) than the former. Sweden also has a relatively high uncertainty avoidance ranking, preferring order, structure and formality, which does not stand out in the case study. Swedes are also high on institutional collectivism but low on family or small-group collectivism. The Italians are the opposite. Unlike the Americans, the Italians are not at all oriented towards achievement (Trompenaars) or performance (GLOBE). They are also more emotional than the Swedes and Americans according to Hofstede and have a relatively low future orientation (GLOBE).

'The way we do things here': the implications of cultural differences for organisations and managers

Mapping out a variety of national cultural typologies using the various dimensions of culture described above gives us some insights into the kinds of differences that exist among different groups of managers, employees and organisations.

Two key questions about the role of the individual in a firm and the role of a firm in a society from Trompenaars' study give us a starting point to explore the management implications of cultural differences. The responses in Figure 5.3 reflect the degree of support for the particular proposition A or B for each of these questions.

(1) People's role within companies

A. An organization is a system where functions and tasks are conducted in an efficient way. Individuals are employed to fulfil these functions.

B. An organization is a collection of people working together. Individuals have social relations with other individuals and the company. The functioning of an organization is reliant on these relations.

US	CAN	BEL	NL	AUS	SWE	UK	IT	GER	SIN	FRA	JAP
74	69	68	61	59	56	55	46	41	39	35	29

A ⟷ B

(2) The role of companies within society

A. The main goal of an organization is to make a profit.

B. Besides making profits an organization should attain the well-being of their stakeholders (e.g. customers, suppliers, employees etc.).

US	AUS	CAN	UK	IT	SWE	NL	BEL	GER	FRA	SIN	JAP
40	35	34	33	28	27	26	25	24	16	11	8

A ⟷ B

Figure 5.3 Excerpts from Trompenaars' cultural attitudes survey

Source: Adapted from C. Hampden-Turner and F. Trompenaars, *The Seven Cultures of Capitalism: Value Systems for Creating Wealth in the United States, Britain, Japan, Germany, France, Sweden and*

the Netherlands (New York: Doubleday, 1993).

Americans clearly display what has been termed (originally by the sociologist Max Weber) a mechanistic and functional view of the firm as an organisation (A) and a shareholder-driven, profit-oriented view of this organisation in society (although more than half the US vote in Figure 5.3 was for option B). The Japanese tend to have a more organic view of the firm, emphasising the importance of social networks and the obligation of the firm to a wider constituency of stakeholders (although this is a characteristic of traditional Japan that has been strongly tested in the recent recessionary environment).

A wide range of factors within organisations are influenced directly or indirectly by the cultural predispositions of managers and employees. We know from the above studies and a wide range of other research that these factors include:

- The general relationship between employees and the organisation: their roles and responsibilities, obligations and loyalties and the link these have with life outside the workplace.
- Hierarchy, power and authority, and the accepted routes to attaining these, including factors that underpin status and credibility in different societies and organisations.
- The role of formal rules and regulations versus the informal communication, personal networks and hidden ‘rules of the game’.
- The accepted basis for decision making, including rationale, scientific, mechanistic and objective versus subjective, tacit, rule of thumb, etc.
- The degree to which employees act and are treated as individuals or groups and the role of interpersonal relationships.
- Motivation and rewards systems.
- Interaction and communication mechanisms.

Table 5.2 Average and intra-country ranking of work goals: a seven-nation comparison

Work goals	Belgium	UK	Germany	Israel	Japan	Netherlands	United States
Opportunity to learn	5.8[a] 7[b]	5.55 8	4.97 9	5.83 5	6.26 7	5.38 9	6.16 5
Interpersonal relations	6.34 5	6.33 4	6.43 4	6.67 2	6.39 6	7.19 3	6.08 7
Opportunity for promotion	4.49 10	4.27 11	4.48 10	5.29 8	3.33 11	3.31 11	5.08 10
Convenient work hours	4.71 9	6.11 5	5.71 6	5.53 7	5.46 8	5.59 8	5.25 9
Variety	5.96 6	5.62 7	5.71 6	4.89 11	5.05 9	6.86 4	6.10 6
Interesting work	8.25 1	8.02 1	7.26 3	6.75 1	6.38 2	7.59 2	7.41 1
Job security	6.80 3	7.12 3	7.57 2	5.22 10	6.71 4	5.68 7	6.30 3
Match between the people and the work	5.77 8	5.63 6	6.09 5	5.61 6	7.83 1	6.17 6	6.19 4
Pay	7.13 2	7.80 2	7.73 1	6.60 3	6.56 5	5.27 5	6.82 2
Working conditions	4.19 11	4.87 9	4.39 11	5.28 9	4.18 10	5.03 10	4.84 11
Autonomy	6.56 4	4.69 10	5.66 8	6.00 4	6.89 3	7.61 1	5.79 8

Notes:

[a] First row shows average rank on a scale of 1 to 10.

[b] Second row shows ranking of work goals within each country, with a rank of 1 being most important and 11 being least important.

Source: Adapted with permission from Itzhak Harpaz, "The importance of work goals: an international perspective," *Journal of International Business Studies*, vol. 21, no. 1 (1990), p. 81, © Springer Nature.

Work attitudes and the appropriate management of work attitudes have a significant influence on productivity and innovativeness in a company. Managers and employees who are motivated by their core social values to work hard and continually strive to improve their company's products and services and the processes by which they are produced are clearly a source of competitive advantage. It is interesting to note how social norms may

drive a strong work ethic despite individual dissatisfaction with workload or job responsibilities. This has been shown in several companies between US and Japanese factory workers where the Japanese are found to be more loyal and aligned with company objectives but far less satisfied individually.[20]

Table 5.2 compares interview responses from sample workforces in seven countries. The resulting ranking of what it is that employees value most from their jobs shows that 'interesting work' is what tends to engage most people, beyond everything else.

CROSS-CULTURAL MANAGEMENT

Three key areas capture many of the factors covered by the above typologies and cultural stereotypes, where cultural differences can make a significant difference at the company-to-company and face-to-face levels. These are organisation, leadership and communication (see Figure 5.4).

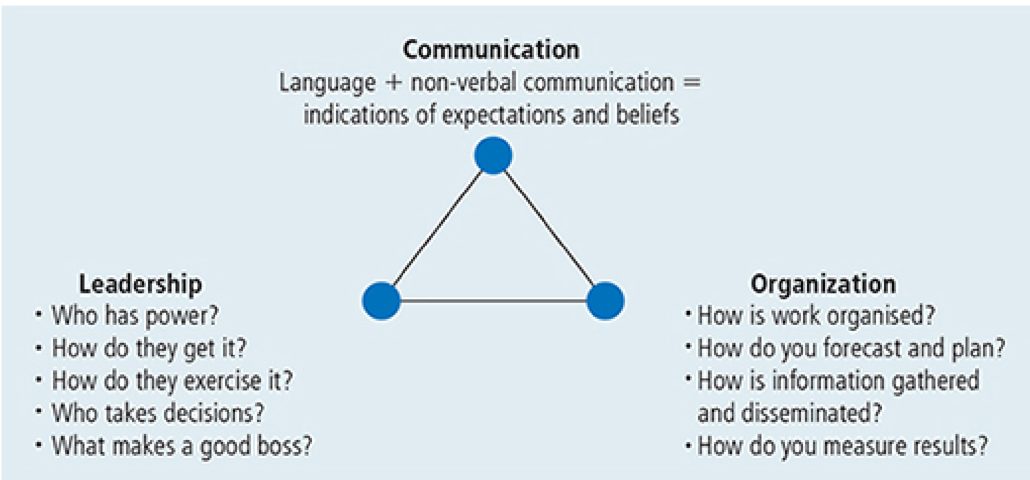

Figure 5.4 Management dimensions of culture

Organisation

Organisation styles range from organic, informal or people oriented to systematic or mechanistic, formal or task oriented, in keeping with some common organisational dimensions described by sociologists throughout history (such as Max Weber and Emile Durkheim). Organisations that operate very much around personal relationships and social networks contrast those that are much more functional and logical. In fact different cultures and different firms display elements of both these characteristics, but the balance varies considerably and can create tensions when groups of

people or firms from different ends of the spectrum interact or try to cooperate.

As an aid to predicting differences among individuals, groups or firms, and understanding the significance of these variations, *relative* differences among countries, organisations and groups of people are important, rather than any absolute scores. For example, family companies are characteristically directive, individual oriented but organic. Multinational firms are usually more autocratic and mechanistic. Consulting and professional services firms are often mechanistic and emphasise individual performance and rewards but may also be fairly team oriented. Entrepreneurial new ventures will usually be organic, unsystematic and group oriented.

Leadership

Leadership styles range from individual oriented, directive, autocratic, top down or authoritarian to group oriented, participative, democratic, bottom up or egalitarian. Again, cultural groups and corporations often encompass both kinds of leadership but tend to reflect one dominant style.

Individual managers from cultures that score high on the power distance or assertiveness dimensions are likely to be viewed by those from other cultures as autocratic and directive, but will tend to view others as indecisive and too compromising. They will not want to spend too much time discussing issues to achieve a consensus. If they also reflect an organic or informal (low uncertainty avoidance) culture, this will result in an instinctive or unsystematic decision-making and implementation style, and they might be viewed as an unpredictable autocrat. This contrasts the combination of high power distance and high uncertainty avoidance, which results in a more directive and mechanistic style. Such leaders prefer established formal routines and a command-and-control bureaucracy, while other managers are

likely to see this as over-regulated and inflexible. The Active Learning Case at the start of the chapter demonstrates a range of these styles and the problems that result from the imposition of a new style of organisation and leadership within a corporate merger.

Communication

Clearly, at the face-to-face level language differences can be the most prominent barrier to communication and therefore to cooperation and coordination. English speakers tend to have an advantage in many situations since English has emerged as the main language of business globally. However, this has led to complacency among some indigenous English speakers, notably the British and the North Americans. First, less effort is often made to learn other languages and their associated cultures, which normally limits a manager's understanding of foreign colleagues, workers or customers. Second, the assumption is often made that once the language barrier is broken cultural differences are also removed, whereas these may remain, causing miscommunication and misinterpretation. As for much of this chapter on culture, preparation and awareness are the best starting points for minimising differences that can create problems.

It is through efficient communication that two parties steer towards an understanding – a mutually agreed basis for doing business. The signs and signals on this route to an understanding are strongly influenced by culture. Different groups have different ways of displaying approval or of showing frustration in negotiations and different ideas of what constitutes a final agreement. The Japanese do not really have an equivalent word for the English 'no' and indicate disapproval in a range of non-verbal ways. The Japanese word *hai* does mean 'yes' but it often means 'yes, I understand what you are saying' not 'yes, I agree with what you are saying'. Germans place a lot of emphasis on written communications and documented

evidence rather than verbal interaction, compared to the Spanish and Italians, to whom verbal interaction and agreement is recognised as binding in some contexts. The Americans prefer legal contracts and have armies of lawyers to make agreements highly specified. Other, more organic business cultures tend to work towards a relationship in which trust and understanding replace the need for legally binding contracts. Again, awareness through preparation and anticipation of differences is the best starting point for avoiding **culture clash**.

The corporate response

How have MNEs responded to the challenge of managing across cultural boundaries? What kinds of organisation structures, HRM procedures and corporate cultures have been developed to cope with the enormous differences among people and to unify this diversity towards a common purpose?

At a very general level, good transnational firms develop an *awareness* and appreciation of cultural differences among their managers and employees. They also take steps to encourage *adaptation* of personal behaviour or organisational practices, or products and services, to suit the changing mix of cultures within the firm, in subsidiaries and in key markets. Training programmes, including a range of activities at the induction stage, when new recruits join a firm or existing personnel take up a role in a new country, are a standard way for firms to do these things. Job rotation, with a focus on developing international managers with personal experience in a variety of different countries, is also practised by a number of firms. It is normally very difficult to assess such practices using any form of cost–benefit analysis. The costs are usually easily identifiable, but the benefits are very often intangible. For many experienced international companies, such

as Shell or Nestlé, a long-term commitment to (and investment in) cultural awareness is simply accepted as a necessary part of being global.

Beyond awareness and adaptation, the best firms aim to *leverage* the diversity of cultures within their organisations and combine the best aspects of different ways of doing things. Corporate culture, a shared identity spanning culturally diverse groups of employees, provides a way to do this. Companies can usefully invest in their own socialisation mechanisms, such as social events alongside regular meetings and conferences. Company magazines, intranets and even in-house television channels for corporate communications can all support this process. These may not only improve cross-cultural awareness, but also promote shared values, symbols and even language to help bind employees together.[21]

Here is a list of other useful strategies for managing cultural diversity distilled from a number of research studies:[22]

1 Recognise diversity. Identify and map the various national cultures and ethnic groups within the firm and use this to understand which elements of consistency and standardisation can or should be promoted.

2 Build diversity issues into recruitment, HRM planning, strategy, location decisions, alliances, and partnerships. This helps avoid clashes and inefficiency and supports cultural awareness.

3 Identify where and to what degree local divisions should be encouraged or empowered to take the lead in expressing and managing diversity. Some degree of devolution of responsibility away from the centre of the firm allows local divisions to identify aspects of diversity that are most important to them and their operations.

4 Encourage cross-border discussion and interaction as well as focused training. Include specific kinds/combinations of international experience for fast-track managers.

5 Aim for a cultural balance in particular areas of strategic and tactical decision making (such as brand changes for foreign markets). Ensure a (numerically) balanced pool of managers or appropriately diverse inputs into decision making.

6 Lead from the top. Aim to match the geographic diversity of the firm's businesses with a culturally mixed senior management group and board of directors (as in the case of Sony and Unilever).

✔ Active learning check

Review your answer to Active Learning Case question 3 and make any changes you like. Then compare your answer to the one below.

3 What could senior managers do before and after mergers to alleviate some of the problems that result from culture clash?

A simple starting point would be to review the various frameworks (Hofstede, Trompenaars, and GLOBE, for example) to understand some generic differences between the national cultures involved in the merger and anticipate some of the likely problems. It would have also helped to examine the potential areas of organisational conflict with senior managers from each company and/or with managers with some experience of two or more of the countries and their ways of doing things. Some degree of cultural training or induction plus an investment in joint meetings and events to get to know each other could also have improved understanding and morale. However, the cost–benefit trade-off for these kinds of pre- and post-merger activity is difficult to precisely assess.

Multinational organisation structures: imperialist or independent?

A key dilemma for international firms is the degree to which they promote or even impose a common, standardised corporate culture across the organisation. Although this will create economies of scale and be more efficient in a number of respects, it will also stifle diversity and create clashes with local cultures and ways of doing things around the organisation.

Firms respond to this dilemma in different ways, with different outcomes. At the simplest level we can map out a range of responses from what is termed *imperialist*, where a common culture is imposed wherever a company has a presence, to *federalist* or *independent* structures, where each

national subsidiary bases its own culture on local norms and values. There are problems associated with either of these extremes and most firms try to steer a middle line, standardising some elements across the whole organisation to centralise and simplify some practices and unify employees, while allowing differentiation where necessary. This *transnational culture* allows for a compromise in work styles, values and approaches, harnessing the strengths that lie in diversity.

Table 5.3 illustrates a range of organisation types. In particular, it links elements of organisation structure and design with cultural orientation, for example in the relationship between headquarters and regional subsidiaries. It specifically extends the ethnocentric, **polycentric** and **geocentric** typologies introduced by Perlmutter in the 1960s.[23]

- *Ethnocentric* firms are where top management is dominated by home-country nationals, and procedures and management styles are transferred from the head office and imposed on regional subsidiaries in place of local ways of doing things.
- *Polycentric* firms tend to act like a federation of semi-autonomous organisations with financial controls or strict reporting structures holding them together. Subsidiaries are able to reflect the local cultural norms, and headquarters appreciates the need for different organisation designs, procedural norms, rewards systems, etc., as long as profits flow to the centre.
- *Geocentric* firms are seen as the ideal, collaborative and meritocratic form of global organisation. (Unilever is seen as an example based on the above statement.) They are characterised by: an equal sharing of power and responsibility between headquarters and subsidiary; senior management promoted according to ability rather than nationality; and

subsidiaries that share worldwide objectives with managers focusing beyond national market interests.

In the geocentric organisation the *benefits* of cultural diversity, such as knowledge of local customers and business practices, are harnessed for the good of the firm as a whole. The *costs* of diversity, such as language and communication problems, different values and different attitudes towards work, are minimised. Firms moving towards this more balanced, geocentric approach have to recognise diversity and its effects and identify which elements of consistency in regulations and values should be promoted, where and when. Local divisions must identify aspects of diversity that are most important to them and their operations and take the lead in expressing and managing these differences. Discussion, interaction, cross-divisional teamwork and job rotation, support, awareness and understanding go alongside training programmes, language courses and cultural assimilation.

Unilever is an example of a firm that has closely examined the range of cultures it encompassed and made a deliberate attempt to use cultural differences as a strength rather than a weakness for fulfilling its strategic aims. As part of a high-profile internal campaign, the company described itself as a *multi-local multinational*, and this was used to explicitly inform employees of its cultural tolerance. According to a statement from a Unilever board chairman, one of the firm's objectives was to 'Unileverize our Indians and Indianize our Unileverians'.[24]

Table 5.3 Organisation types reflecting cultural predispositions

	Imperialist	Interventionist	Interactive	Independent
Organisation	Ethnocentric	Ethnocentric	Geocentric	Polycentric
Structure	Steep hierarchy	Flat hierarchy	Network	Federation
Strategy	Dictated	Centrally decided	Jointly specified	Locally specified
Decision making	Centralised	Distributed	Shared	Devolved

Culture clash in cross-border M&A and joint ventures

The range of organisation styles in Table 5.3 also reflects the range of ways multinational firms approach the management of joint ventures or of firms acquired through merger and acquisition (M&A). They can either impose their own style of management on these organisations or allow them the independence to reflect their own cultural norms and existing corporate cultures.[25]

More than half of all mergers destroy shareholder value. Remember AOL–Time Warner, Quaker–Snapple or Daimler–Chrysler. In the latter case, a number of senior-level US managers either were asked to leave or left because they were unhappy about the style of management imposed by Daimler. Among these early leavers were members of the design team responsible for the PT Cruiser and other Chrysler successes of the late 1990s. Many went to arch-rival General Motors, which is not an unusual outcome. One study showed that on average 20 per cent of a firm's top management will leave within one year of being acquired and 70 per cent will go within five years.[26]

Cultural differences often prove to be a significant post-merger barrier for managers looking to realise the synergies and added value of pooling the resources and capabilities of two companies from different parts of the world. The Active Learning Case at the start of this chapter illustrates this clearly. Culture clash and its impact on the bottom line are often complex and difficult to predict. More often failure to anticipate culture clash results from the lack of awareness on the part of senior managers and deal-makers driving the M&A strategy. Financial analyses that focus on the due diligence process of counting up assets and identifying cost-cutting benefits tend to miss any estimation of cultural and organisational synergy (or lack thereof). Anticipating such problems and preparing for the development of effective

relationships between people from both sides of an M&A or an alliance is central to maximising the rewards.

Conducting a 'cultural gap analysis' is one way of examining these differences prior to, or in the early stages of, a merger.[27] This consists of a survey questionnaire where employees rank particular workplace processes on a Likert scale (e.g. 1 = low, 5 = high), such as: 'decisions are made at the top and handed down the organisation', or: 'I am willing to work at weekends if requested.' The responses from both of the merged/merging organisations are compared to assess overall differences. This provides a mapping of potential areas of culture clash.

Cultural awareness and some degree of organisational adaptation can limit the number of key people who do leave following a cross-border M&A. Understanding how to predict and mitigate the negative effects of cultural differences should be on the agenda for all managers. Despite this, in some cases an ethnocentric, imperialist approach is precisely what is needed to drive a newly merged organisation forward. When Carlos Ghosn led the partial takeover of Nissan by Renault, he imposed a very non-Japanese way of doing things on the firm. In terms of the firm within its broader economic and social context, breaking *keiretsu* ties and laying off employees were radical steps to take. Internally he instituted performance-related pay and promotion and cut through a range of traditional rituals around HRM, budget control and decision making that were underpinned by the traditional Japanese culture of the company. These were the kinds of changes that needed to be made to reverse years of losses and indebtedness. It was also, arguably, impossible for the incumbent Japanese management to make such changes. Since then Carlos Ghosn has fallen off his pedestal faces charges of embezzlement, arguably a symbol of the benefits and costs of culture clash in management (Chapter 17, on Japan, contains the full Nissan–Renault case).

At the other end of the spectrum, reflecting again on Table 5.3, Tata Tea Limited, owner of 54 tea estates and the second-most popular tea brand in India, provides us with an example of a successful M&A which followed the ‘independent’ approach vis-à-vis its newly acquired subsidiary. In March 2000 it bought one of the UK’s top tea brands, Tetley Tea, some say on the basis of profits at Tata Consulting Services, the successful IT and software arm of the $9 billion Tata conglomerate. Coming more than 50 years after the end of 200 years of British colonial rule that had supported British ownership of tea estates in India, this shift of power is an appropriate symbol for the twenty-first century. But the takeover was barely noticed by the British public. In stark contrast to the imperialist approach of the British in India all those years ago, Tata took a hands-off approach, allowing the existing management, with its local knowledge and experience, to continue running Tetley. A federal structure with devolved decision making is supported by a polycentric organisational style.[28]

INTERNATIONAL BUSINESS STRATEGY IN ACTION

The collective culture of John Lewis & Partners

Founded in 1864 in London, John Lewis & Partners (JLP) is an employee-owned organisation that primarily operates two businesses, John Lewis department stores and Waitrose supermarkets. This highly unusual ownership structure was established by John Spedan Lewis, the son of the founder, who signed away his ownership rights in 1929, paving the way for an ‘experiment in industrial democracy’. At the heart of the company’s constitution is the principle of establishing a ‘better form of business.’ Staff ‘happiness’ and a democratic, inclusive culture, with management encouraging input and ideas from staff to help shape how the businesses are run, all continue to be central to the firm’s ethos.

With a focus on delivering high-quality products and customer service, JLP has successfully grown to operate 353 Waitrose stores and 50 John Lewis retail stores with a workforce of over 90,000 employees. In 2018 JLP had revenues of approximately $13.3 billion ($8.3 billion Waitrose and $5 billion John Lewis) and accumulated profits of $554 million ($224 million Waitrose and $330 million John Lewis). Since 2015, JLP have experienced a decrease in profits (26 per cent down year-on-year) as a result of a number of market factors, including:

- supermarket price wars (as Lidl, Aldi and ASDA got into their stride on the UK high street), leading particularly to reductions in like-for-like sales with other supermarkets and a downward push on prices;
- a rise in pension costs, by $78 million, as the firm tackled its $1.6 billion pension deficit;
- redundancy payments offered to staff within three distribution centres set to close, affecting over 250 employees.

As an employee-owned organisation, all staff within the JLP group receive a bonus based on their individual salary and the organisation has been praised by various political factions in the UK as a model of caring capitalism. In 2014, all staff received a 15 per cent pay out as a bonus, which was itself a reduction by 2 per cent from the previous year. In 2015, following the above

performance, the bonus pay-out was reduced to 11 per cent. This has continually decreased and at the start of 2019 JLP announced that it may suspend all staff bonuses as the retail slump continues.

The company's ownership model leads to a number of positive effects. First, the bonus structure means it is in the interests of all managers and staff to work hard, innovate and continually improve because they personally benefit when the firm performs well. But equally important is the corporate culture that this structure promotes. It is a more egalitarian organisation, with directors of the business paid substantially less than counterparts in rivals like Sainsbury's or Tesco and staff receiving perks including theatre outings, access to holiday homes and various subsidised clubs. It is also one that is benchmarked because of the commitment, dedication and friendliness of staff. Customers report excellent shop-floor service and this leads to more sales, but it also leads to greater employee satisfaction. Staff are rewarded and 'empowered'.

Finally, the 'partnership spirit' at John Lewis benefits the wider communities in which the firm's offices and shops are located. The firm and its staff operate in the spirit of a social enterprise, working with local charities and volunteer groups. This was led from the top by Andy Street, who was the Managing Director of JLP from 2007 to 2016. Street left JLP as he pursued a career in politics and became mayor of the West Midlands in 2017. Andy Street worked for many years with policy-makers and universities in the region to drive forward a renaissance in the Birmingham city region, where John Lewis built its flagship store in 'Grand Central' Birmingham in 2015.

Source: JLP, *Annual Report*, 2014, 2018; Michael Pooler and Andrea Felsted, 'Price war and pension costs hit John Lewis*', Financial Times*, 10 September 2015; Andrea Felsted, 'John Lewis expected to cut staff bonuses', *Financial Times*, 6 March 2015; Graham Ruddick, 'John Lewis profits fall as costs and competition increase', *Guardian*, 10 September 2015; 'John Lewis says pensions to hit profits', *BBC News*, 10 September 2015.

Active learning check

Review your answer to Active Learning Case question 4 and make any changes you like. Then compare your answer to the one below.

4 Explain why one organisation might want to impose some of its ways of doing things on another, such as an acquired firm or subsidiary.

Standardising ways of doing things across the overall organisation can be more efficient, to a certain extent. Differences can create difficulties in communication, teamwork, motivation or coordination, and the impact on company performance can be significant. It is important to make the distinction between the values, beliefs and norms, plus the associated work practices and management structures that stem from the dominant national culture (the imposition can then be described as ethnocentric) or from the corporate culture. In the latter case the firm will be aiming to derive the benefits of having a shared culture that bridges the national cultural differences across the overall organisation.

Cultural differences between groups of people in the one firm, or between the employees of two firms engaged in a joint venture, are not necessarily a problem. However, when they do create difficulties in terms of communication, teamwork, motivation or coordination, the impact on company performance can be significant, despite the fact that clear cause-and-effect relationships are often difficult to identify precisely. Rather than suggesting a single 'best practice' for dealing with this, the examples above suggest that solutions are context specific.

CULTURE EMBODIED IN NATIONAL INSTITUTIONS

The second level at which we can analyse cultural differences and their effects is at the institutional level, where national cultural characteristics are *embodied* in institutions from government agencies and governance mechanisms to the education system, economic institutions and business organisations.

Firms engaging in cross-border joint ventures or M&As need to take account of the national context in which the new partner or acquired firm is situated. Similarly, when marketing and selling products in a new national market, these broader differences matter. A country's distinctive political, legal and institutional context partly reflects its dominant national culture. Education systems, labour laws, environmental regulations, capital markets and the relationships between private sector businesses and public sector organisations will vary accordingly.[29]

Trompenaars uses his findings simply to divide various countries into subgroups reflecting shared characteristics stemming from common cultural influences (Figure 5.5).

- *Western pluralism* emphasises individual competitiveness, commonly represented by separate ventures competing in price-defined markets for success. Survival of the fittest is the catchphrase, and companies tend to be run as meritocracies.
- *Command economies* are centrally planned hierarchies with less individualism and less individual incentive. Clearly, as global politics changes, countries are tending to move out of this category. For

example, Poland is now an emerging capitalist country reflecting the characteristics of Western pluralism more than a command economy.

- *Organic ordering* refers to the family-centred hierarchies of Asia, southern Europe and Latin America. Inter- and intra-organisation interaction is based around information sharing and collaborative competition.
- *Structured networks* reflect the more equal, structured relationships between companies and with public sector organisations that exist in some countries.

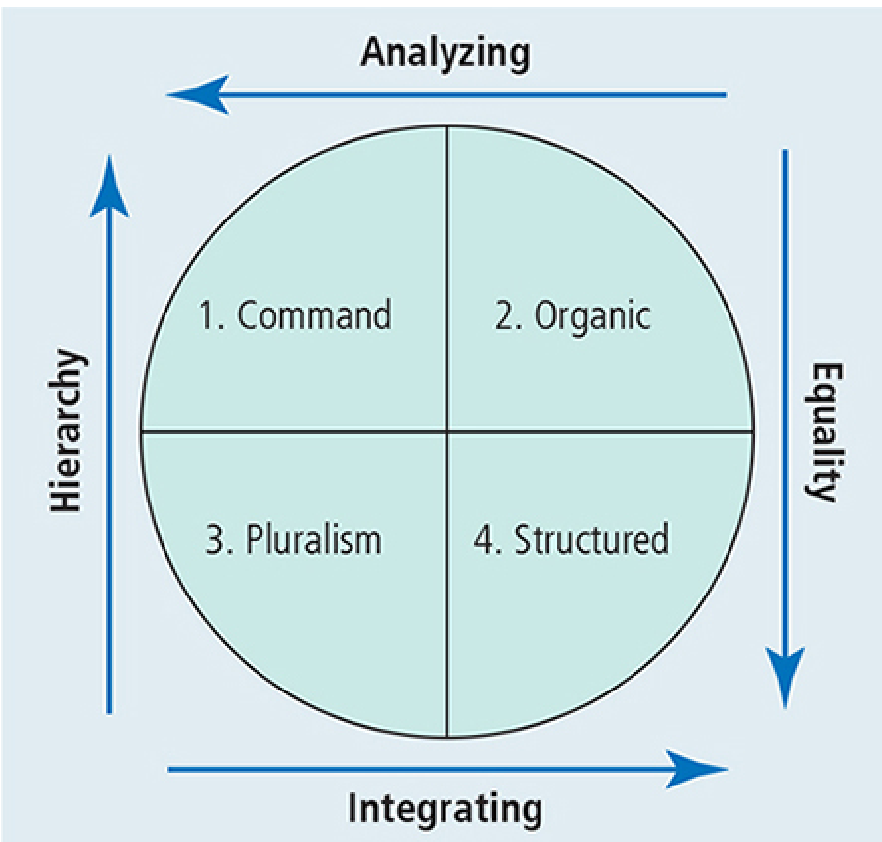

Figure 5.5 Shared characteristics stemming from common cultural influences

Source: Adapted from C. Hampden-Turner and F. Trompenaars, The Seven Cultures of Capitalism: Value Systems for Creating Wealth in the United States, Britain, Japan, Germany, France, Sweden and the Netherlands (New York: Doubleday, 1993).

France, with some comparisons with other Western economies and organisations, provides an example, giving a snapshot of some of the main characteristics that stem from the country's cultural distinctiveness.

France: cultural and social characteristics that create a national distinctiveness

National characteristics

- Central planning, national protectionism for domestic industry and strong government intervention in the market (compared to other European economies) lie at the heart of the French system. Civil servants are intellectual and respected as in Japan (but not the UK) and well paid (unlike in Japan).
- Communication tends to be vertical (up–across–down). Bypassing official channels is not common: uncertainty reduction tends to predominate.
- Hierarchy is important, bureaucracy respected. Clear hierarchy, divisionalisation, and rules and regulations guide behaviour. However, this exists alongside a respect for maverick gestures and individuals or groups that overcome the obstacles and beat the system.
- Government-to-business links are formal and informal, with the elitist groups from the *grandes écoles* bridging public and private sectors at the senior level. Ascription dominates over achievement compared to the UK or the United States, again with parallels with Japan.
- Competition occurs at school age when success determines assignment to a particular *cadre* or *echelon* inside and outside the workplace (depending on the school attended as much as individual performance).
- France has a large number of family-owned and managed firms. It does not have the **Mittelstand** (small technical and engineering firms) that

underpin the chemical and machine tool industries in Germany.

- Capital markets are competitive but are not as ‘short-termist’ as in the UK and the United States, with an overwhelming emphasis on share values and dividends. France does not have the strong interfirm networks that exist in Germany and Japan (*keiretsu*), which include links between financial institutions (banks, institutional shareholders) and the companies they fund.

French organisations

- French companies also tend to be hierarchical, bureaucratic and well structured, but there is a strong view of the company as a social entity (an **esprit de corps**) with an emphasis on obligation and loyalty rather than individual gain.
- Despite moves towards a more equal relationship, French managers continue to have a supervisory role over workers. German and Japanese managers, by comparison, tend to be more collegiate and cooperative across levels of the hierarchy, including mentoring arrangements between senior and junior managers.
- Hierarchical relationships are diffuse (in Trompenaars’ terminology) rather than limited to the workplace (France ranks highest among European countries along this dimension). Companies have a responsibility towards the wider society, and managers, because of their professional status, have a role to play in society.
- Scientific management techniques, termed **gestion**, dominate, which parallels German zeal for quantification and measurement to guide performance improvement.
- There is a premium on technical and on-the-job training (similar to Germany and Japan). Marketing and accountancy skills are less valued

than in the UK and the United States.

- A surprise to many observers is that one-fifth of the labour force is unionised. French labour law (*Code du Travail*) is comprehensive and enforced. Companies are relatively loyal to their employees compared to British or US firms, but there is not the strong social contract that exists in Japan.

KEY POINTS

1. Culture can be defined as 'the sum total of the beliefs, rules, techniques, institutions, and artefacts that characterise human populations'.
2. Cultural differences can have an important effect at the face-to-face or company-to-company levels and need to be taken into account in dealing with different groups of customers around the world.
3. Culture can be analysed at two levels: the psychic distance between groups of people, and the differences in culture embodied in national institutions and socio-economic systems.
4. Hofstede, Trompenaars and the GLOBE researchers have constructed useful frameworks for understanding broad differences between national cultures which underpin differences in the design of organisations and the behaviour of managers and employees.
5. Differences in organisation, leadership and communication can be used to measure differences in groups and individuals and help managers anticipate when and why cultures may clash.
6. Company responses to the challenges of managing diversity range from the imperialist to the independent approaches.
7. Ethnocentric firms impose a common culture on all subsidiaries; polycentric firms allow subsidiaries to reflect local ways of doing things; and geocentric firms maintain a balance between centre and subsidiary.
8. When in Japan, do not throw your *meishi*!

Key terms

- **grande école**
- **culture**
- **socialisation**
- **corporate culture**
- **ethnocentrism**
- **cultural convergence**
- **psychic distance**
- **power distance**
- **uncertainty avoidance**
- **individualism**
- **masculinity**
- **universalism**
- **particularism**
- **collectivism**
- **neutral**
- **emotional**
- **specific**
- **diffuse**
- **achievement oriented**
- **ascription oriented**
- **sequential**
- **synchronic**

- **humane orientation**
- **culture clash**
- **polycentrism**
- **geocentrism**
- **Mittelstand**
- **esprit de corps**
- **gestion**

REVIEW AND DISCUSSION QUESTIONS

1 In your own words, what is meant by the term *culture*?

2 In what way do ethnocentrism and misconceptions about other cultures inhibit those doing business internationally?

3 Why is language so critical in understanding international culture? How can this problem be dealt with effectively?

4 Why are cultural differences an important factor when adapting products for new overseas markets?

5 Use Trompenaars' seven dimensions of culture to compare and contrast your own national stereotype to another.

6 Why are work attitudes of importance to MNEs? Cite and describe two examples.

7 What kinds of reward systems are likely to be effective in more individualistic and achievement-oriented cultures like the United States?

8 Explain how the GLOBE project has extended the dimensions of national culture beyond the work of Hofstede and Trompenaars.

9 In the Pharmacia–Upjohn merger how did employment practices and workplace regulations differ among the Americans, the Swedes and the Italians, and what impact did these differences have on the operational efficiency of the merged company?

10 Show with examples how managers in multinational firms could improve their employees' awareness of the important differences among cultures.

11 What are the benefits of and the problems for a polycentric MNE?

12 Why is an understanding of the institutional norms, regulations and practices of other countries important for international firms? Give examples to illustrate your answer.

13 What does the French term *gestion* mean?

REAL CASE

Konami is watching its employees

Konami is an iconic Japanese organisation operating in the entertainment and gaming industry. In 2018, Konami employed approximately 4,500 people and was performing rather well, earning revenues of $2.19 billion, an increase of 4.2 per cent on the previous year. Of this, $413 million was profit, a 24.3 per cent rise from the previous year. Konami reported that approximately 50 per cent of this revenue came from the sales of digital entertainment, which include mobile games, card games and computer/video games. The latest iteration of one of Konami's flagship games, 'Pro Evolution Soccer: 2018', was exceptionally successful in North America. Furthermore, 'Yu-Gi-Oh! Duel Links', a mobile game based upon the traditional card playing game had over 65 million downloads worldwide. Part of the success of these games is the Japanese styling of the characters and the game-play, which is novel for Western players.

Konami has become a firm fan favourite as it publishes cult-class games Metal Gear, Silent Hill and Castlevania. However, trouble seemed to be brewing when Hideo Kojima, who is regarded as a veteran games producer/director within the gaming community, left the organisation in late 2015. His departure resulted in the cancellation of the highly anticipated 'Silent Hills' game, the latest chapter in the Silent Hill franchise. Konami also went on to remove Kojima's name from the box art of Metal Gear Solid V, a franchise which Kojima led on for almost 30 years. The controversy of Kojima, who had garnered an adoration from fans, leaving the company left a negative impression among the gaming community.

Nikkei released a report on Konami in 2018, outlining some issues concerning the management of this Japanese firm. First, the report discussed the departure of Kojima, suggesting the high costs of the latest Metal Gear project, which had an $80 million budget, were to blame. However, this type of budget is not unusual in the development of triple A games; to put this into context, Grand Theft Auto 5, developed by Rockstar, was reported to have cost around $265 million. Konami's commitment to reducing spending on traditional console games also impacted other game series including Momotaro Dentetsu, Tokimeki Memorial, Love Plus and Suikoden, the creators of which have also left Konami.

The Nikkei report also raised other concerns about the culture of Konami. Following Kojima's departure in 2015, his former team were renamed 'Number 8 Production Department' and computers within their studio were disconnected from the internet, with employees only permitted to send internal messages. Furthermore, employees leaving the premises on their lunch breaks were having their absences monitored with time cards, and the employees who stayed out too long were allegedly having their names announced throughout the company, in moves reminiscent of a Big Brother culture. Furthermore, ex-Konami employees have stated that to prevent employees from being headhunted by competitors, the majority of Konami staff do not have permanent email addresses, and change them frequently. The style of these addresses is also anonymising, typically formatted with random letters and numbers, in a bid to dispel unsolicited external contact. Only those employees from whom it is necessary to engage with external stakeholders, such as those employees in sales and PR have permanent contact details.

Konami also reportedly changed employee roles based upon individual performance. For instance, game developers regarded as not being 'useful' or who underperform were reassigned to jobs as security guards or cleaning staff at the company's fitness clubs. Importantly, these moves were not consigned to junior employees, but also producers who have worked on well-known game titles. An ex-employee of Konami also went on to state that Konami moved him from game development to working in Konami's pachi-slot factory, causing him to experience severe depression. In addition, the same ex-employee stated that upon announcing his departure from the firm in Facebook, any Konami peers who 'liked' the post were soon reshuffled within the company.

The culture at Konami is seen to be very hierarchical, as is common within family-run businesses, especially in Japan. Konami are owned by the Kozuki family who appear to want to safeguard the competitive assets of the firm by limiting the power and influence of outsiders on the business. For instance, the founder of the company, Kagemasa Kozuki, is Chairman while his son, Takuya Kozuki, serves as the firm President. Moreover, both Kozuki's nephew and son-in-law serve on the board of directors. In total, four out of the seven internal directors of the company are part of Kozuki family. Although the way the Konami conducts its business may seem 'harsh', it is important to understand that the culture adopted in Japanese businesses is in stark contrast to that

in Western organisations. In fact, understanding Japan's culture can potentially explain why many of the decisions illustrated in this case study were implemented.

There is strong emphasis placed on loyalty and obligation between employees and their firms in Japan. Lifetime employment based on a moral contract (rather than a price-based contract) and a manager's position as a member of a collective have a strong influence on an individual's behaviour when interacting with others. *Kaisha-in* literally means 'company person', but it also denotes the individual as a representative of 'our company' in the sense of a shared group consciousness. *Meishi* ('business cards') have a deep significance in Japan as the representation of the employee's allegiance to and respect for his/her company. The company name comes first, before the individual's name on the *meishi* and when making introductions. The exchange of *meishi* also establishes relative rank within the strict corporate and social hierarchy, and therefore guides the correct behaviour and even form of language used during interactions. Overall, for the Japanese exchanging *meishi* is an important symbolic ritual.

Although the Konami example is extreme, even by Japan's standards, reports have suggested that some of the practices and control mechanisms implemented within Konami would not raise eyebrows in other Japanese firms. Difficulties arise, however, when a firm becomes more global in terms of its employees and its sales and branding. Employees from other cultures and often legal institutions in other countries would not accept these workplace practices. Consumers from some countries would also change their view of the firm, its brand and products in light of these practices. Company's like Konami therefore have trade-offs between local and international ways of doing business which are determined by cultural differences. Managers need to understand the full costs and benefits of different ways of working to succeed across different country markets and cultures.

Websites: https://www.forbes.com/sites/insertcoin/2015/08/03/scathing-konami-report-alleges-cruel-and-unusual-employee-practices/#36a254dc408b; https://www.polygon.com/2015/8/3/9089247/konami-nikkei-report-workplace-culture-metal-gear-solid; https://variety.com/2018/gaming/news/konami-silent-metal-gear-survive-1202807407/; https://kotaku.com/report-konami-is-treating-its-staff-like-prisoners-1721700073

Source: S. Collinson, *Small and Successful in Japan: A Study of 30 British Firms in the World's Most Competitive Market* (London: Avebury Press/Ashgate Publishing Group, 1996); C. Nakane, *Japanese Society* (Tokyo: Charles E. Tuttle, 1973).

1 Discuss what kinds of broad cultural differences are likely to exist between Japan and the US.

2 Which of Hofstede's cultural dimensions are demonstrated in the way Konami conducts its business?

3 Explain the difficulties Japanese firms may face when becoming more global.

REAL CASE

Sport can be local *and* global: Manchester United

For most sports there appears to be a natural connection with the cultures and communities of particular locations and even individual venues. Often history plays a strong role, even when sports are played internationally. St. Andrews Links Course, Lord's Cricket Ground and Wembley Stadium all have a particular symbolism to players and fans of golf, cricket and soccer in and beyond the UK.

These contrast with more 'placeless' global sporting events, particularly the Olympic Games, which involve most nations of the world. Rather than creating a sense of common identity, such events can reinforce national cultural identities through international competition.

Other sports remain local: Japanese sumo wrestling, Aussie rules football and hurling in Ireland, for example, where the connection with national culture, community and history are strongest. American football is played in several countries but only seriously in the United States. It is not only a huge commercial enterprise but, like basketball and baseball, strongly embedded in local communities through schools and colleges, as an important symbol of US cultural identity.

Some sports could be defined as regional, such as baseball which is predominantly based in North America, but also popular in Japan and played little elsewhere. A few sports are marked on a global basis, although not all parts of the triad are fully involved. Golf, tennis and soccer have global television audiences and advertising revenues. Among these, soccer is recognised as the biggest, played by an estimated 240 million people with 1.5 million teams and 300,000 clubs worldwide. Many countries, from Brazil to Cameroon, Italy to South Korea, would claim the game as an important part of their popular national culture. But soccer is not a major sport in North America, where it ranks well behind American football, baseball, hockey and car racing.

Source: Russell Hart/Alamy Stock Photo

Europe hosts some of the major soccer club brands, with 52 leagues and a combined value over $25 billion. Within this the English Premiership is worth over $11 billion with many of the top 20 most valuable teams from the Premier League. One of the leading clubs in the Premiership is Manchester United – not your average soccer club, but certainly one of the best illustrations in the sporting world of the evolving mix between local cultural heritage and international business.

Born in 1878, Manchester United long epitomised the connection between the local team and the local community. Its fan base was dominated for over a hundred years by local people, with Trafford Park and the Manchester Ship Canal, one of the world's first industrial centres, at its heart. The grassroots, blue-collar, working-man's passion and fierce loyalty remain at the cultural heart of the club today. Rather than symbolising English culture, it demonstrates the strength and persistence of the regional subculture of England's industrial northwest. This is reinforced by strong rivalry with other leading clubs such as Liverpool, Arsenal and Chelsea. Now the brands of these teams are very multinational.

In the early 1990s, despite strong growth in international merchandising sales through Manchester United Merchandising, over 90 per cent of revenues to the club still came from the domestic UK market. But a growing global fan club, the international spread of *Manchester United Magazine*, and the growing availability of televised games beyond the UK (particularly via Rupert

Murdoch's global media networks) led to an export drive in the late 1990s and early 2000s. Countries with national teams but few big league teams, such as Ireland, Scandinavia, and a range of Asian countries, where soccer is watched by millions on TV, became the club's best markets. By 2002 the global club membership had grown to 200 branches in 24 countries, and with profits of over $25 million on a turnover of over $100 million, it was considered the world's wealthiest club. MUTV, the club's own TV channel, and a large range of internet sites fuelled interest in the team. By 2003 Manchester United had attracted an estimated global fan base of 53 million.

Major sponsorship deals with Nike and later Vodafone (at $15 million per year) boosted its finances and its global brand footprint. In 2014, Manchester United signed a new ten-year record-breaking sponsorship and licensing deal with Adidas, which guarantees the club an average income of £110 million per year. Furthermore, Manchester United signed a seven-year shirt deal with Chevrolet, which paid the club approximately $75 million during the 2014–15 season. In 2018 Manchester United announced their first ever sleeve sponsorship deal with Kohler, where the US manufacturing company's logo will be on placed on the left sleeve for both men and women's team. This sponsorship has been reported to be worth £20 million per season, which would make it the biggest yet for inventory in the Premier League. However, the partnership with Kohler is not to end there but has been said to include joint participation on game day activities, improvements to club facilities and other initiatives aimed to sync some of the fans with Kohler customers.

The cross-border takeover by the US-based Glazer family in 2005 made the club even more international by any definition. Boosted by wins in the Premiership, the FA Cup, and the European Champions League, the club's fan base had grown to an estimated 75 million worldwide. Significantly, 40 million of these were in Asia, compared to 23 million in Europe. Since then the actual number of global fans has been in dispute, ranging from 'over 50 million' to 'over 300 million'.

By this time the club had a range of regional sponsors, with PepsiCo, Anheuser-Busch InBev and Schick in North America, Ladbrokes in Europe, and Fuji Film and Air Asia in Asia. These were co-branding partners alongside global sponsors such as AIG, Vodafone, Nike and Audi (and a few local partners like Dimension Data in South Africa). In some cases these have been the route

to joint products and services, such as content services delivered by cell phone to Manchester United fans through Vodafone.

Despite the fact that, on average, over half the team comprises foreign players who play against the England national team in the World Cup, and despite the fact that the club's fan base is (in terms of pure numbers) more Asian than English, the passion for the club is still as strong as ever around Manchester. Global sports teams like Manchester United are embedded in local folklore, passionately discussed in bars and clubs around the world, part of the cultural identity of communities, but at the same time they are multinational businesses with global brands and international strategies.

In 2018 Manchester United generated revenues of $676 million, placing them as number 1; they were them closely followed by Real Madrid who generated $674 million. As of 2018 Manchester United is worth $4.8 billion, and there are eight British clubs in the top 20 and six in the top 10, the others being Manchester City ($2.5 billion) Arsenal ($2.2 billion), Chelsea ($2.0 billion), Liverpool ($1.9 billion) and Tottenham Hotspur ($1.2 billion).

Source: A. Rugman, *The End of Globalization* (London: Random, 2001); R. Bennet and J. Blythe, *International Marketing*, 3rd ed. (London: Kogan Page, 2002); W. Manzenreiter and J. Horne, *Football Goes East: Business, Culture and the People's Game in China, Japan and South Korea* (New York: Routledge, 2004); G. P. T. Finn and R. Giulianotti, *Football Culture* (New York: Routledge, 2000); 'Neo-imperialism at the point of a boot', The *Economist*, 11 March 2007, p. 56; http://www.manutd.com; 'Real top Man Utd in rich league', *BBC News*, 14 February 2008; 'Manchester United can break £100m barrier for commercial turnover', *Guardian*, Friday, 13 May 2011; Mike Ozanian, 'Real Madrid tops ranking of the world's most valuable teams', *Forbes*, accessed from https://www.forbes.com/sites/mikeozanian/2018/06/12/the-worlds-most-valuable-soccer-teams-2018/#2e5eb5fd45c8; http://www.forbes.com/soccer-valuations/; http://www.sportspromedia.com/news/manchester-united-kohler-sleeve-sponsorship.

1 What makes a sport local, regional or global?

2 What major drivers are responsible for the internationalisation of Manchester United?

3 How important are Manchester United’s strong local roots to its international success?

NOTES

1 UNCTAD, *World Investment Report*, 2018, United Nations, Geneva; http://www.unctad.org

2 D. A. Ball and W. H. McCulloch, *International Business: The Challenge of Global Competition*, 7th ed. (Boston, MA: Irwin McGraw-Hill, 1999), p. 258.

3 G. Hofstede, *Culture's Consequences: International Differences in Work Related Values* (Beverly Hills, CA: Sage, 1980).

4 M. Gelfand (2018) *Rule Makers, Rule Breakers: How Tight and Loose Cultures Wire Our World* (New York: Scribner Books).

5 K. Voigt, 'Japanese firms want English competency', *Wall Street Journal*, 11 June 2001, p. B7B.

6 M. Weber, *The Protestant Ethic and the Spirit of Capitalism*, 2nd Roxbury ed. (London: Roxbury, 1993).

7 K. A. Nordström and J.-E. Vahlne, 'Is the globe shrinking? Psychic distance and the establishment of Swedish sales subsidiaries during the last 100 years', in M. Landeck (ed.), *International Trade: Regional and Global Issues* (Basingstoke: St. Martin's Press, 1994).

8 Many texts refer back to the work of Hall as one of the earliest authors in this field; E. T. Hall, 'The silent language of international business', *Harvard Business Review* (May–June 1960), pp. 87–96.

9 G. Hofstede, 'The cultural relativity of organizational practices and theories', *Journal of International Business Studies* (fall 1983), p. 92; G. Hofstede, *Cultures and Organizations; Software of the Mind: Intercultural Cooperation and Its Importance for Survival* (London: Harper Collins, 1983).

10 B. McSweeny, ‘Hofstede’s model of national cultural differences and their consequences: a triumph of faith—a failure of analysis’, *Human Relations*, vol. 55, no. 1 (2002), pp. 89–118, cites additional problems in a stronger critique of Hofstede’s approach. R. Jowell, ‘How comparative is comparative research?’, *American Behavioral Scientist*, vol. 42, no. 2 (1998), pp. 168–78, meanwhile suggests that Hofstede and other analysts’ cross-national data are too concerned with ‘league tables of distributions showing merely “gee whiz” national differences’ rather than offering explanations and interpretations.

11 G. Hofstede, *Culture’s Consequences: Comparing Values, Behaviors, Institutions and Organizations across Nations*, 2nd ed. (Thousand Oaks, CA: Sage, 2001); G. Hofstede et al., ‘What goals do business leaders pursue? A study in fifteen countries’, *Journal of International Business Studies*, vol. 33, no. 4, (2002), pp. 785–804.

12 F. Trompenaars, *Riding the Waves of Culture: Understanding Cultural Diversity of Business* (London: Nicholas Brealey, 1993); F. Trompenaars and C. Hampden-Turner, *Riding the Waves of Culture: Understanding Cultural Diversity in Global Business* (London: Nicholas Brealey, 1998); Fons Trompenaars and Charles Hampden-Turner also run a consultancy specializing in advice and training on cross-cultural issues. The website for the firm has some useful resources for further research: http://www.7d-culture.nl/. A similar site, with a range of tools and techniques for understanding and managing differences in European cultures, is: http://www.johnmole.com

13 C. C. Chen, ‘New trends in rewards allocation preferences: a Sino-US comparison’, *Academy of Management Journal* (April 1995), p. 425; Y. Ono and B. Spindle, ‘Japan’s long decline makes one thing rise: individualism’, *Wall Street Journal*, 29 December 2000, pp. A1, 4.

14 M. Javidan and R. J. House, ‘Cultural acumen for the global manager: lessons from project GLOBE’, *Organizational Dynamics*, vol. 29, no. 4 (2001), pp. 289–305.

15 https://globeproject.com/

16 D. A. Light, ‘Cross-cultural lessons in leadership’, *MIT Sloan Management Review* (fall 2003), pp. 5–6.

17 This has involved 38 universities in annual surveys of around 7,000 organizations across Europe; C. J. Brewster and H. Harris (eds.), *International Human Resource Management: Contemporary Issues in Europe* (London: Routledge, 1999); C. Brewster, ‘HRM practices in multinational enterprises’, in M. J. Gannon and K. Newman (eds.), *Handbook of Cross-cultural Management* (Oxford: Blackwell, 2001); J. Van Ommeren et al., ‘The Cranet Survey 1999’, *UK Executive Report 1999*, Cranfield Network on European Human Resource Management, Cranfield, Bedford.

18 P. C. Earley, ‘Leading cultural research in the future: a matter of paradigms and taste’, *Journal of International Business Studies*, vol. 37, no. 6 (2006), pp. 922–31; G. Hofstede, ‘What did GLOBE really measure? Researchers’ minds versus respondents’ minds’, *Journal of International Business Studies*, vol. 37, no. 6 (2006), pp. 882–96; P. B. Smith, ‘When elephants fight, the grass gets trampled: the GLOBE and Hofstede projects’, *Journal of International Business Studies*, vol. 37, no. 6 (2006), pp. 915–21.

19 C. Nakane, *Japanese Society* (Tokyo: Charles E. Tuttle, 1973).

20 J. R. Lincoln, ‘Employee work attitudes and management practice in the United States and Japan: evidence from a large comparative survey’, *California Management Review* (fall 1989), p. 91.

21 There are many firms that offer advice and training services to help companies improve their cultural awareness and the ability of

employees to adapt to cultural diversity. A useful starting point, however, is G. Wederspahn, ‘Do your employees need intercultural services?’ (2002), http://www.grovewell.com/pub-cultural-knowledge.html

22 Financial Times, *Managing Global Business, Mastering Management Series* (London: Pearson, 2000); M. C. Gentile, *Managerial Excellence through Diversity: Text and Cases* (Chicago, IL: Irwin, 1996); D. A. Thomas and R. J. Ely, ‘Making differences matter: a new paradigm for managing diversity’, *Harvard Business Review* (September–October 1996), pp. 79–90.

23 H. V. Perlmutter, ‘The tortuous evolution of the multinational enterprise’, *Columbia Journal of World Business*, vol. 4, no. 1 (1969), pp. 9–18.

24 Perlmutter in C. A. Bartlett and S. Ghoshal, *Text, Cases and Readings in Cross-Border Management*, 3rd ed. (Boston, MA: McGraw-Hill International Editions, 2000), p. 77.

25 S. C. Collinson, ‘M&A as imperialism?’, in D. Angwin (ed.), *Images of M&A* (Oxford: Blackwell, 2006).

26 J. P. Walsh, ‘Top management turnover following mergers and acquisitions’, *Strategic Management Journal*, vol. 9 (1988), pp. 173–83.

27 L. M. Mitchell, P. Mirvis and R. Ashkenas (2014). Making the Most of Culture Clash in M&A. *Leader to Leader*.

28 S. C. Collinson in D. Angwin, *Images of M&A* (Oxford: Blackwell, 2006).

29 R. P. Appelbaum, W. Felstiner, and V. Gessner (eds.), *Rules and Networks: The Legal Culture of Global Business Transactions* (Oxford: Hart Publishing, 2001); R. Whitley, *Competing Capitalisms: Institutions and Economies* (Cheltenham: Edward Elgar, 2002); R.

Whitley, *The Multinational Firm: Organizing across Institutional and National Divides* (Oxford: Oxford University Press, 2001); R. Whitley, *Divergent Capitalisms: The Social Structuring and Change of Business Systems* (Oxford: Oxford University Press, 1999).

BIBLIOGRAPHY

Ashkanasy, Neil M., Trevor-Roberts, Edwin and Earnshaw, Louise. 'The Anglo cluster: legacy of the British empire', *Journal of World Business*, vol. 37, no. 1 (2002).

Barr, Pamela S. and Glynn, Mary-Ann. 'Cultural variations in strategic issue interpretation: relating cultural uncertainty avoidance to controllability in discriminating threat and opportunity', *Strategic Management Journal*, vol. 25, no. 1 (2004).

Berry, Heather, Guillén, Mauro F. and Nan Zhou, 'An institutional approach to cross-national distance', *Journal of International Business Studies*, vol. 41, no. 9 (2010).

Beugelsdijk, S., Kostova, T. and Roth, K. 'An overview of Hofstede-inspired country-level culture research in international business since 2006', *Journal of International Business Studies*, vol. 48, no. 1 (2017).

Chevrier, Sylvie. 'Cross-cultural management in multinational project groups', *Journal of World Business*, vol. 38, no. 2 (2003).

Collinson, Simon C., *Small and Successful in Japan: A Study of 30 British Firms in the World's Most Competitive Market* (London: Ashgate Press, 1996).

Collinson, Simon C. and Houlden, John. 'Decision making and market orientation in the internationalisation process of small and medium-sized enterprises', *Management International Review*, vol. 45, no. 4 (2005).

Collinson, Simon C. and Pettigrew, Andrew M.. 'Comparative international business research methods: pitfalls and practicalities.' In

A. Rugman (ed.), *The Oxford Handbook of International Business*, 2nd ed. (Oxford: Oxford University Press, 2009), Table 3.1, Chapter 27.

Devinney, Timothy M. and Jan Hohberger. ‘The past is prologue: moving on from culture’s consequences’, *Journal of International Business Studies*, vol. 48, no. 1 (2017).

Early, P. Christopher. ‘Leading cultural research in the future: a matter of paradigms and taste’, *Journal of International Business Studies*, vol. 37, no. 6 (November 2006).

Fealy, Liz and Kompare, Dave. ‘When worlds collide: culture clash’, *Journal of Business Strategy*, vol. 24, no. 4 (2003).

Friday, Ernest and Friday, Shawnta S. ‘Managing diversity using a strategic planned change approach’, *Journal of Management Development*, vol. 22, no. 10 (2003).

Hampden-Turner, Charles and Trompenaars, Fons. *The Seven Cultures of Capitalism: Value Systems for Creating Wealth in the United States, Britain, Japan, Germany, France, Sweden and the Netherlands* (New York: Doubleday, 1993).

Han, Sam, Kang, Tony, Salter, Stephen and Yoo, Yong Keun. ‘A cross-country study on the effects of national culture on earnings management’, *Journal of International Business Studies*, vol. 41, no. 1 (2010).

Hofstede, Geert. ‘What did GLOBE really measure? Researchers’ minds versus respondents’ minds’, *Journal of International Business Studies*, vol. 37, no. 6 (November 2006).

Javidan, Mansour, House, Robert J., Dorfman, Peter J., Hanges, Paul J. and Sully de Luque, Mary. ‘Conceptualizing and measuring cultures and their consequences: a comparative review of GLOBE’s and Hofstede’s approaches’, *Journal of International Business Studies*, vol. 37, no. 6 (November 2006).

Kostova, Tatiana and Roth, Kendall. ‘Social capital in multinational corporations and a micro-macro model of its formation’, *Academy of Management Review*, vol. 28, no. 2 (2003).

Leung, Kwok, Bhagat, Rabi, Buchan, Nancy R., Erez, Miriam and Gibson, Cristina B. ‘Beyond national culture and culture-centricism: a reply to Gould and Grein (2009)’, *Journal of International Business Studies*, vol. 42, no. 1 (2011).

McSweeny, Brendan. ‘Hofstede’s model of national cultural differences and their consequences: a triumph of faith – a failure of analysis’, *Human Relations*, vol. 55, no. 1 (2002).

Mead, Richard and Andrews, Tim G. *International Management: Cross-cultural Dimensions*, 4th ed. (Oxford: Wiley-Blackwell, 2009).

Mole, John. *Mind Your Manners: Managing Business Cultures in Europe* (London: Nicholas Brealey, 1996).

Muethel, Miriam, Hoegl, Martin and Parboteeah, K. Praveen. ‘National business ideology and employees’ prosocial values’, *Journal of International Business Studies*, vol. 42, no. 2 (2011).

Ronen, S. and Shenkar, O. ‘Mapping world cultures: cluster formation, sources and implications’, *Journal of International Business Studies*, vol. 44, no. 9 (2013).

Sarala, Riikka M. and Vaara, Eero. ‘Cultural differences, convergence, and crossvergence as explanations of knowledge transfer in international acquisitions’, *Journal of International Business Studies*, vol. 41, no. 8 (2010).

Schneider, Susan C. and Barsoux, Jean-Louis. *Managing Across Cultures*, 2nd ed. (London: Prentice Hall, 2003).

Shao, Liang, Kwok, Chuck C. Y. and Zhang, Ran. ‘National culture and corporate investment’, *Journal of International Business Studies*, vol. 44, no. 7 (2013).

Shenkar, O. ‘Cultural distance revisited: toward a more rigorous conceptualization and measurement of cultural differences’, *Journal of International Business Studies*, vol. 43, no. 1 (2012).

Simon, David G. and Lane, Peter J. ‘A model of cultural differences and international alliance performance’, *Journal of International Business Studies*, vol. 35, no. 4 (2004).

Sivakumar, K. and Nakata, Cheryl. ‘The stampede toward Hofstede’s framework: avoiding the sample design pit in cross-cultural research’, *Journal of International Business Studies*, vol. 32, no. 3 (fall 2001).

Smith, Peter B., Peterson, Mark F. and Thomas, David C. *The Handbook of Cross-Cultural Management Research* (Thousand Oaks, CA: Sage, 2008).

Triandis, Harry C. ‘The many dimensions of culture’, *Academy of Management Executive*, vol. 18, no. 1 (2004).

Tung, Rosalie L. and Verbeke, Alain. ‘Beyond Hofstede and GLOBE: improving the quality of cross-cultural research’, *Journal of International Business Studies*, vol. 41, no. 8 (2010).

Tung, Rosalie L. and Stahl, Günter K. ‘The tortuous evolution of the role of culture in IB research: What we know, what we don’t know, and where we are headed’, *Journal of International Business Studies*, vol. 49, no. 9 (2018).

Venaik, Sunil and Brewer, Paul, ‘Avoiding uncertainty in Hofstede and GLOBE’, *Journal of International Business Studies*, vol. 41, no. 8 (2010).

West, Joel and Graham, John L. ‘A linguistic-based measure of cultural distance and its relationship to managerial values’, *Management International Review*, vol. 44, no. 3 (2004).

Zeng, Y., Shenkar, O., Lee, S. H. and Song, S., ‘Cultural differences, MNE learning abilities, and the effect of experience on subsidiary mortality in

a dissimilar culture: evidence from Korean MNEs', *Journal of International Business Studies*, vol. 44, no. 1 (2013).

Chapter 6

INTERNATIONAL TRADE

Contents

Objectives of the chapter

An understanding of international trade is critical to the study of international business. The primary objective of this chapter is to examine key economic theories that help to explain why

nations trade. In addition, the role and importance of a country's barriers to trade will be studied and discussion will focus on why most nations use trade barriers despite vigorous international efforts to eliminate them.

The specific objectives of this chapter are to:

1. *Define* the term *international trade* and discuss the role of mercantilism in modern international trade.
2. *Contrast* the theories of absolute advantage and comparative advantage.
3. *Relate* the importance of international product life cycle theory to the study of international economics.
4. *Explain* some of the most commonly used barriers to trade and other economic developments that affect international economics.
5. *Discuss* some of the reasons for the tensions between the theory of free trade and the widespread practice of national trade barriers.

ACTIVE LEARNING CASE

US–China trade war: battle of the giants

A decade on from 2008's financial crisis, another major challenge to international trade and multinational firms occurred, in the form of a trade war between the US and China. The origins behind the trade war can be traced back to 2014, before Donald Trump was elected as US President and even before he started his presidential campaign, to Trump's demands for a crackdown on China's trade policies with the US. Trump's threats against China started to gain momentum during his political campaign in 2016 where he asserted, '[the US] can't continue to allow China to rape our country, and that's what they're doing'. In 2017, the first year of Trump's presidency, the US officially announced that they were launching an investigation into Chinese trade policies, with a heavy emphasis on intellectual property. The US justified this investigation by stating that counterfeit goods, pirated software and the theft of US trade secrets by China cost the American economy approximately \$600 billion (£470 billion) a year.

A thaw in relations appeared in mid-2017, as the relationship between Trump and Xi Jinping, President of China, appeared amicable and both parties quickly resolved a trade deal concerning a sub-set of traded products including beef and poultry. But by 2018, the world's two largest economies went aggressively head-to-head with a series of additional tariffs and new trade barriers. Tariffs act as protectionist trade barriers by imposing additional costs on imported products, making domestic products cheaper or more cost-competitive by comparison. The US government was eager to impose tariffs to simply encourage US consumers to buy more American goods. However, this trade war created a turbulent political arena for nations trading all over the world: today's global integrated economy means that a battle between the largest economies have a significant ripple effect, a lesson undoubtedly learnt from the 2008 economic meltdown.

Table 6.1 The 2018 US–China Trade War: ten key events

US	2018	China
1. Tariff of 20%–50% on washing machines and tariff of 30% on solar panels	January	
2. Tariff of 25% on steel and tariff of	February	

10% on aluminium		
	March	
	April	3. Tariffs accounting for $3 billion in goods from US
4. Negotiations between US and China representatives fail to end trade war	May	4. Negotiations between US and China representatives fail to end trade war
5. Tariffs accounting for $50 billion in goods from China	June	6. Tariffs accounting for $50 billion in goods from US
	July	
	August	
7. Tariffs accounting for $200 billion in goods from China	September	8. Tariffs accounting for $60 billion in goods from US
	October	
9. Trade negotiations between Trump and Xi begin	November	9. Trade negotiations between Trump and Xi begin
10. Trump and Xi meet at G-20 summit	December	10. Trump and Xi meet at G-20 summit
Several rounds of tariffs on China totalling more than $250 billion.		Several rounds of retaliation tariffs on the US totalling more than $130 billion.

Table 6.1 maps out the key moves and counter-moves on both sides after the US imposed its first tariff, on a particular range of washing machines and solar cells. This was a clear attempt to provide firms like Whirlpool, an American MNE that manufactures home appliances, an advantage over the Chinese conglomerate Haier. The tariff consisted of a 20 per cent tariff on the first 1.2 million imported washers in the first year and a 50 per cent tariff on subsequent imports. The tariffs were set to reduce to 16 per cent for the first 1.2 million washing machines and 40 per cent on above 1.2 million washing machines in the third year. However, this move did not only impact China, but also punished South Korea who supply a large quantity of washing machines to the US under flagship brands such as Samsung and LG. With regard to solar cells, the US declared that a 30 per cent tariff was to be imposed in year one and that this would gradually decrease to a tariff of 15 per cent by year 4, but this measure did allow for 2.5 gigawatts of unassembled solar cells per year to be imported with no tariffs.

In February, Trump continued his initial attack by imposing worldwide import tariffs of 25 per cent and 10 per cent on aluminium and steel respectively. Although China was the US's prime

target, the fact that this was a globally imposed tariff meant that many countries and trading groups were quick to retaliate. For instance, the EU stated that the tariffs were unfair and extremely protectionist, and in turn they revealed plans to place tariffs on certain products from the US, namely: orange juice; denim; motorbikes and peanuts. In addition, neighbouring countries Mexico and Canada were quick to hit back with their own levies on US imports. For instance, Mexico placed tariffs on pork bellies, apples, grapes, cheeses and flat steel. Although Mexico certainly exports more to the US than it imports, Mexico was the second largest market for US exports, having purchased $277 billion worth of US products and services in 2017. Importantly, the intention behind Trump’s tariffs was to protect US jobs, but these tariffs were hurting the US economy too as approximately 110,000 US jobs are directly tied to US pork exports to Mexico and other countries. Meanwhile, Canada placed duties on $12.8 billion worth of US goods. By way of a contrast, in exchange for being spared the costs of tariffs set on steel, Brazil, Argentina and Australia all agreed that they would limit the quantity of steel shipments to the US. At this point in time the US also asserted that all tariffs were to remain on Japanese imports.

April 2018 marked the first of China’s retaliations to US’s trade restrictions, but its approach was more measured, restricting 128 US products that totalled an import value of only $3 billion, far lower than Trump’s Chinese tariffs, which were thought to be valued at $60 billion. Moreover, US goods that were exported to China were worth around $115.6 billion in 2017, so Beijing’s small focus on just $3 billion of US imports was a cautious move; they did not want escalate the situation and prompt further retaliation from the US. China tends to assert that it is a nation that champions global trade but it is important to note that it has strong protectionist measures in place affecting particular industry sectors. Foreign companies, for example, have limited access to certain markets and oblige foreign investors to form partnerships with Chinese firms in areas like aviation, information and communications technology (ICT) sectors and banking. Foreign firms are compelled to share their technological know-how, often resulting in counterfeit products, in exchange for market access. China’s relatively small strike on the US was perhaps a strategic decision designed to show the world that they were a trade globalist and to distance themselves from the heavily protectionist stance taken by the US.

Representatives from the US and China met in May in a bid to reach some middle ground, but this meeting ultimately failed to end the trade war. June was an important month as this was the first time Xi Jinping decided to impose equivalent tariffs on the US. For instance, after May's deliberations, Trump announced a 25 per cent tariff on other Chinese products, valued at $50 billion worth of Chinese goods. China responded immediately by implementing tariffs valued at $50 billion of American goods.

The US responded again later that summer, imposing tariffs worth $200 billion on Chinese goods, representing a staggering four times the value of the previous attack in June. These new tariffs meant that 40 per cent of all Chinese goods sold to the US were now impacted. Given this, US consumers would inevitably witness a rise in price for goods such as, but not limited to, handbags, furniture, bicycle tyres and air-conditioning units. The new tariffs would start at 10 per cent during the end of September 2018 and rise to 25 per cent the following year. Trump also stepped up the level of aggression by asserting that if Xi were to retaliate, then he would seek to deliver the knockout punch ending this trade war by immediately increasing extra tariffs worth $267 billion of Chinese imports. If this did occur, it would have meant that all goods imported to the US from China would be subjected to tariffs. However, Xi was quick to retaliate and Beijing declared that they were going to implement tariffs of their own on US goods including small aircraft, computers, textiles, chemicals, meat, wheat and wine. Although, again, these tariffs would only account for around $60 billion – just a quarter of the amount imposed by the US.

Closely following this exchange of blows, many US firms started to voice their concerns. 3M, a global consumer-goods manufacturer, suggested that overall tariffs on China's imports was ultimately having a negative impact on their total sourcing costs. More specifically, Nick Gangestad, 3M's Chief Financial Officer, highlighted that the tariffs would leave the firm with approximately $100 million in headwind to deal with. Tesla also reported that the new tariffs would cost the firm $50 million in the fourth quarter of 2018 alone and Harley-Davidson reported costs of around $43–$48 million for the same time period. Ford then joined in, stating that aluminium and steel tariffs set at the start of 2018 had cost the automotive giant approximately $1 billion, despite sourcing the majority of their metal components from the US.

The circular nature of the global economy, with large interdependencies between US firms and Chinese suppliers, as well as large numbers of US businesses reliant on China's growing market to maintain their own revenues, began to create a backlash against these protectionist policies. Trump did not impose any further heavy tariffs against China for the rest of 2018. Trump and Xi restarted their negotiations in November, finally meeting each other face-to-face at the G-20 summit in December. The trade negotiations continued into 2019 with few tangible outcomes. If tariffs against China are not lifted by the US, then the future appears challenging for MNEs and it would not be surprising if such firms decide to re-locate certain operations to overcome current restrictions. For instance, during the start of 2019 Apple announced they would be shifting the production of their high-end iPhones from China to India, and although this is inevitably a costly and risky move, the firm stated that they believe this is a risk they need to take to avoid being caught in the crossfire between the US and China.

The US and China trade war is the largest of its kind in economic history. After several rounds of tariffs, the US imposed tariffs on $250 billion worth of goods from China, with threats of increasing this to over $500 billion. In contrast, China's tariffs on US goods totalled approximately $130 billion, and while these are still sizable, they are relatively modest in comparison with the US's actions. In January 2019, the World Bank issued a warning stating that the impact of the US and China trade war is likely to have global repercussions over the next few years. More specifically, they speculate that a global recession is likely to occur by 2020, as the global integrated economy is predicted to slow to 2.9 per cent by the end of 2019, compared with 3 per cent in 2018. For the global knock-on effects of trade wars to be minimised, political leaders like Trump and Xi need to quickly focus on economic compromise in place of political brinkmanship.

Sources: https://www.cnbc.com/2018/11/30/timeline-of-us-china-tradewar-as-trump-and-xi-meet-at-g-20-in-argentina.html; https://www.iol.co.za/business-report/economy/world-bank-issues-stark-warning-on-us-china-tradewar-impact-18757982; https://www.theguardian.com/environment/2018/jan/23/trump-imposes-steep-tariffs-on-imported-solar-panels-and-washing-machines; https://www.nbcnews.com/news/us-news/trump-team-advocates-burning-fossil-fuels-even-u-s-scientists-n946826; https://news.sky.com/story/trumps-

tariffs-what-you-need-to-know-11391050; https://money.cnn.com/2018/06/06/news/economy/mexico-us-tariffs-retaliation/index.html; https://www.bbc.co.uk/news/business-45899310; https://www.telegraph.co.uk/business/2018/09/17/donald-trump-announces-tariffs-200-billion-chinese-goods/; https://www.businessinsider.com/trump-tariffs-china-tradewar-us-companies-prices-2018-10?r=US&IR=T; https://www.forbes.com/sites/davidvolodzko/2019/01/17/will-apple-become-the-tradewars-next-victim/#75a51a3e3617.

1. **How do trade wars work against the principles supported by the theory of comparative advantage?**
2. **What reasons were given for the start and subsequent escalation of the US–China trade war in 2017–18?**
3. **How can trade barriers negatively affect third countries who are not directly targeted in a trade war?**

INTRODUCTION

International trade is the branch of economics concerned with the exchange of goods and services with foreign countries. Although this is a complex subject, we will focus on two particular areas: international trade theory and barriers to trade.

Some international economic problems cannot be solved in the short run. Consider the US balance of trade deficit. US trade with Japan and China heavily affects its overall imbalance. Moreover, this trade deficit will not be reduced by political measures alone; it will require long-run economic measures that reduce imports and increase exports. Other nations are also learning this lesson – and not just those that have negative balances. After all, most countries seem to want a continual favourable trade balance, although this is impossible, since a nation with a deficit must be matched by a nation with a surplus.[1]

The complexity of global value chains, in services and manufacturing, make international trade an even more important topic today. Currency shifts, inflation and, in many cases, unemployment present critical challenges alongside trade interdependencies across countries. However, there is strong evidence that open trade brings growth and prosperity to the world economic system. Since the time of Adam Smith in 1790, economists have shown that free trade is efficient and leads to maximum economic welfare. More recently, new trade theory and its variants have suggested that governments intervene in markets 'intelligently' to enhance the benefits of international trade. In this chapter we will discuss the economic rationale for free trade, the political impediments to it and some newer interpretations of how trade policy should be managed.

INTERNATIONAL TRADE THEORY

To understand the topic of international trade, we must be able to answer the question: why do nations trade? One of the earliest and simplest answers to this question was provided by **mercantilism**, a theory that was quite popular in the eighteenth century, when gold was the only world currency. Mercantilism holds that a government can improve the economic well-being of the country by encouraging exports and stifling imports. The result is a positive balance of trade that leads to wealth (gold) flowing into the country.

Neo-mercantilism, like mercantilism, seeks to produce a positive balance of trade but without the reliance on precious metals. Most international trade experts believe that mercantilism is a simplistic and erroneous theory, although it has had followers. For example, under President Mitterrand in the late 1970s and early 1980s, France sought to revitalise its industrial base by nationalising key industries and banks and subsidising exports over imports. By the mid-1980s the French government realised that the strategy was not working and began denationalising many of its holdings.[2] More recently, China has proven to be a strong adherent of mercantilism, as reflected by the fact that it tries to have a positive balance with all of its trading partners.

A more useful explanation of why nations trade is provided by trade theories that focus on specialisation of effort. The theories of absolute and comparative advantage are good examples.

Theory of absolute advantage

The **theory of absolute advantage** holds that nations can increase their economic well-being by specialising in the production of goods they can

produce more efficiently than anyone else. A simple example can illustrate this point. Assume that two nations, North and South, are both able to produce two goods, cloth and grain. Assume further that labour is the only scarce factor of production and thus the only cost.

Labour cost (hours) of production for 1 unit

	Cloth	Grain
North	10	20
South	20	10

Thus lower labour-hours per unit of production mean lower production costs and higher productivity per labour-hour. As seen by the data in the table, North has an absolute advantage in the production of cloth since the cost requires only 10 labour-hours, compared to 20 labour-hours in South. Similarly, South has an absolute advantage in the production of grain, which it produces at a cost of 10 labour-hours, compared to 20 labour-hours in North.

Both countries gain by trade. If they specialise and exchange cloth for grain at a relative price of 1:1, each country can employ its resources to produce a greater amount of goods. North can import 1 unit of grain in exchange for 1 unit of cloth, thereby paying only 10 labour-hours for 1 unit of grain. If North had produced the grain itself, it would have used 20 labour-hours per unit, so North gains 10 labour-hours from the trade. In the same way, South gains from trade when it imports 1 unit of cloth in exchange for 1 unit of grain. The effective cost to South for 1 unit of cloth is only the 10 labour-hours required to make its 1 unit of grain.

The theory of absolute advantage, as originally formulated, does not predict the exchange ratio between cloth and grain once trade is opened, nor does it resolve the division of the gains from trade between the two countries. Our example assumed an international price ratio of 1:1, but this

ratio (P_{cloth} to P_{grain}) could lie between 2:1 (the pre-trade price ratio in South) and 1:2 (the pre-trade price ratio in North). To determine the relative price ratio under trade, we would have to know the total resources of each country (total labour-hours available per year), and the demand of each for both cloth and grain. In this way we could determine the relative gains from trade for each country.

Even this simple model of absolute advantage has several important implications for international trade. First, if a country has an absolute advantage in producing a product, it has the potential to gain from trade. Second, the more a country is able to specialise in the good it produces most efficiently, the greater its potential gains in national well-being. Third, the competitive market does not evenly distribute the gains from trade *within* one country. This last implication is illustrated by the following example.

Prior to trade, the grain farmers in North work 20 hours to produce 1 unit of grain that could be exchanged for 2 units of cloth. After trade, those who remain can exchange 1 unit of grain for only 1 unit of cloth. Thus, the remaining grain producers are worse off under trade. Cloth producers in North, however, work 10 hours, produce 1 unit of cloth, and exchange it for 1 unit of grain, whereas previously they received only half a unit of grain. They are better off. If grain producers in North switch to cloth production, then 20 hours of labour results in the production of 2 units of cloth, which they can exchange for 2 units of grain. Thus, international trade helps them. As long as North does not specialise completely in cloth, there will be gainers (cloth producers and grain producers who switched to cloth) and losers (those who continue as grain producers).

Because the nation as a whole benefits from trade, the gainers can compensate the losers and there will still be a surplus to be distributed in some way. If such compensation does not take place, however, the losers (continuing grain producers) will have an incentive to try to prevent the

country from opening itself up to trade. Historically, this problem has continued to fuel opposition to a free trade policy that reduces barriers to trade. A good example is Japanese farmers who stand to lose their livelihood if the government opens up Japan to lower-priced agricultural imports.

A more complicated picture of the determinants and effects of trade emerges when one of the trading partners has an absolute advantage in the production of both goods. However, trade under these conditions still brings gains, as David Ricardo first demonstrated in his theory of comparative advantage.

Theory of comparative advantage

The **theory of comparative advantage** holds that nations should produce those goods for which they have the greatest relative advantage. In terms of the previous example of two countries, North and South, and two commodities, cloth and grain, Ricardo's model can be illustrated as follows:

Labour cost (hours) of production for 1 unit

	Cloth	Grain
North	50	100
South	200	200

In this example North has an absolute advantage in the production of *both* cloth and grain, so it would appear at first sight that trade would be unprofitable, or at least that incentives for exchange no longer exist. Yet trade is still advantageous to both nations, provided their *relative* costs of production differ.

Before trade, 1 unit of cloth in North costs (50/100) hours of grain, so 1 unit of cloth can be exchanged for half a unit of grain. The price of cloth is half the price of grain. In South, 1 unit of cloth costs (200/200) hours of grain, or 1 grain unit. The price of cloth equals the price of grain. If North

can import more than half a unit of grain for 1 unit of cloth, it will gain from trade. Similarly, if South can import 1 unit of cloth for less than 1 unit of grain, it will also gain from trade. These relative price ratios set the boundaries for trade. Trade is profitable between price ratios (price of cloth to price of grain) of 0.5 and 1. For example, at an international price ratio of two-thirds, North gains. It can import 1 unit of grain in return for exporting 1.5 units of cloth. Because it costs only 50 hours of labour to produce a unit of cloth, its effective cost under trade for 1 unit of imported grain is 75 labour-hours. Under pre-trade conditions it costs North 100 labour-hours to produce 1 unit of grain. Similarly, South gains from trade by importing 1 unit of cloth in exchange for two-thirds of a unit of grain. Prior to trade, South spent 200 labour-hours producing the 1 unit of cloth. Through trade, its effective cost for 1 unit of cloth is ⅔ × 200, or 133 labour-hours – cheaper than the domestic production cost of 200 labour-hours. Assuming free trade between the two nations, North will tend to specialise in the production of cloth, and South will tend to specialise in the production of grain.

This example illustrates a general principle. There are gains from trade whenever the relative price ratios of two goods differ under international exchange from what they would be under conditions of no trade. Such domestic conditions are often referred to as *autarky*, which is a government policy of being totally self-sufficient. Research shows that free trade is superior to autarky. In particular, free trade provides greater economic output and consumption to the trade partners jointly than they can achieve by working alone. By specialising in the production of certain goods, exporting those products for which they have a comparative advantage, and importing those for which they have a comparative disadvantage, the countries end up being better off.

The general conclusions of the theory of comparative advantage are the same as those for the theory of absolute advantage. In addition, the theory of

comparative advantage demonstrates that countries jointly benefit from free trade (under the assumptions of the model) even if one has an absolute advantage in the production of *both* goods. Total world efficiency and consumption increase.

As with the theory of absolute advantage discussed previously, Ricardo's theory of comparative advantage does not answer the question of the distribution of gains between the two countries, or the distribution of gains and losses between grain producers and cloth producers within each country. No country will lose under free trade, but in theory at least, all the gains could accrue to one country and to only one group within that country.

✔ Active learning check

Review your answer to Active Learning Case question 1 and make any changes you like. Then compare your answer to the one below.

1. **How do trade wars work against the principles supported by the theory of comparative advantage?**

The theory of comparative advantage holds that nations should produce those goods and services for which they have the greatest relative advantage. By doing so, both countries prosper through exchange; their economic growth and the resulting wealth created, is greater than if they did not trade. Trade wars involve adding costs through tariff and non-tariff barriers, which reduce natural comparative advantages and reduce the incentives to trade. Both parties are worse-off economically as a result.

Factor endowment theory

In recent years, more sophisticated theories have emerged that help clarify and extend our knowledge of international trade. The **factor endowment theory** holds that countries will produce and export products that use large amounts of production factors that they have in abundance, and they will import products requiring large amounts of production factors that they lack. This theory is also known as the **Heckscher–Ohlin theory** (after the two economists who first developed it). The theory is useful in extending the concept of comparative advantage by bringing into consideration the endowment and cost of production factors. The theory also helps explain why nations with relatively large labour forces, such as China, will concentrate on producing labour-intensive goods, whereas countries like the

Netherlands, which has relatively more capital than labour, will specialise in capital-intensive goods.

However, factor endowment theory has some weaknesses. One weakness is that some countries have minimum wage laws that result in high prices for relatively abundant labour. As a result, they may find it less expensive to import certain goods than to produce them internally. Another weakness is that countries like the United States export relatively more labour-intensive goods and import capital-intensive goods – an outcome that appears surprising. This result, discovered by Wassily Leontief, a Nobel Prize-winning economist, is known as the **Leontief paradox** and has been explained in terms of the quality of labour input rather than just labour-hours of work. The United States produces and exports technology-intensive products that require highly educated labour. The Leontief paradox not only shows one of the problems with factor endowment theory, but also helps us understand why no single theory can explain the role of economic factors in trade theory. Simply put, the subject is too complex to be explained with just one theory.

International product life cycle theory

Another theory that provides insights into international theory is Vernon's **international product life cycle (IPLC) theory**, which addresses the various stages of a good's life cycle. In particular, the theory helps explain why a product that begins as a nation's export often ends up becoming an import. The theory also focuses on market expansion and technological innovation – concepts that are relatively de-emphasised in comparative advantage theory. IPLC theory has two important tenets: (1) technology is a critical factor in creating and developing new products; and (2) market size and structure are important in determining trade patterns.

Product stages

The IPLC has three stages: new product, maturing product and standardised product. A new product is one that is innovative or unique in some way (see Figure 6.1(a)). Initially, consumption is in the home country, price is inelastic, profits are high and the company seeks to sell to those willing to pay a premium price. As production increases and outruns local consumption, exporting begins.

As the product enters the mature phase of its life cycle (see Figure 6.1(b)), an increasing percentage of sales is achieved through exporting. At the same time, competitors in other advanced countries will be working to develop substitute products so they can replace the initial good with one of their own. The introduction of these substitutes and the softening of demand for the original product will eventually result in the firm that developed the product now switching its strategy from production to market protection. Attention will also be focused on tapping markets in less developed countries.

As the product enters the standardised product stage (see Figure 6.1(c)), the technology becomes widely diffused and available. Production tends to shift to low-cost locations, including less developed countries and offshore locations. In many cases the product will end up being viewed as a generic, and price will be the sole determinant of demand.

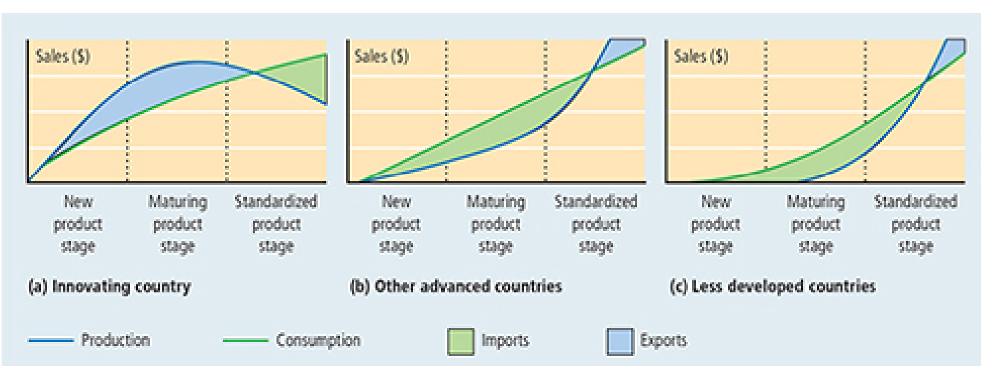

Figure 6.1 **The international product life cycle**

Source: Raymond Vernon and Louis T. Wells, Jr., *The Manager in the International Economy* (Englewood Cliffs, NJ: Prentice Hall, 1991), p. 85.

Apple products and the IPLC

We can track most products and product families through the IPLC to the standardised product stage. Apple's iPhones have followed a fairly regular pattern since the first was launched in 2007, with each upgrade (3G, 3GS, 4, 4S, 5, 5S/5C, 6/6 Plus, SE, 7/7 Plus etc.) showing a rapid growth in global sales soon after launch, quickly stabilising into maturity before the next model was launched. Eleven major models in 10 years, demonstrates a faster rate of 'churn' compared to iPads and MacBooks. The first Apple iPad/iPad Air was launched in 2009 and is still sold, although sales peaked in 2012–13. The iPad Mini launched in early 2012 and peaked in 2015 but is still actively promoted in the market and the iPad Pro was launched in 2015 with sales still rising in 2017–18. Three major products in eight years for the iPad.

For both iPhones and iPads the introduction of a new model clearly accelerated the decline in sales of the previous model. This is less clear in the case of the MacBook. The first was launched in 2005 and we saw only four main product launches from 2005 to 2017. The MacBook Air, launched at the start of 2006, has almost maintained its sales volume for this entire period, despite the launch of the MacBook Pro in mid-2007 which saw declining sales from 2012–13, and the launch of the MacBook Retina in late-2014. There have, of course, been a series of upgrades and modifications for all these products within the cycles of distinctive models.

The respective corporate functions in Apple and the external contractors in various supply chains associated with these products, such as R&D, design, production and marketing are distributed around the world. As predicted by the IPLC framework, in the mature or standard phase of mass-

production the products are manufactured in cheap labour locations (particularly in China).[3]

The IPLC theory is useful in helping to explain how new technologically innovative products fit into the world trade picture. However, because new innovative products are sometimes rapidly improved, it is important to remember that one or two versions of them may be in the standardised product stage while other versions are in the maturing stage and still others are in the new product phase.

Other important considerations

Many factors beyond those we have considered greatly influence international trade theory.[4] One is government regulation. Countries often limit or restrict trade with other countries for political reasons. For example, despite the benefits of international trade, the EU does not always see eye to eye with the United States on regulatory matters. As a result there are different government regulations affecting business in Europe than in North America. For example, EU competition policy differs from US antitrust policy; see the case **International Business Strategy in Action: Microsoft shows the world is not flat**. Other important factors include monetary currency valuation and consumer tastes.

Monetary currency valuation

When examining why one country trades with another, we need to consider the **monetary exchange rate**, which is the price of one currency stated in terms of another currency. In 2015 China's central bank devalued the renminbi by 2 per cent against the US dollar. This made Chinese exports marginally cheaper relative to competitors. Further significant falls in 2018 were a factor in the trade dispute triggered by President Trump in that year. A more significant example was the long-term decline of the value of the

Japanese yen from 1995 to 1998, resulting in a boost for Japanese exports to the United States and Europe. Imported products and services are also relatively more expensive for consumers in countries which experience currency devaluation, driving them to buy locally produced substitutes.

Another reason why monetary currency valuation is important is because a foreign firm doing business will report its revenues and profits in home-country currency. So if a British firm sold $10 million of machinery in Canada and the value of the Canadian dollar declined against the British pound, the UK company would report less revenue (in terms of British pounds) than if the Canadian dollar had remained stable or, better yet, increased in value against the pound. In mid-2005, the euro became so strong compared to the dollar that Volkswagen reported a 63 per cent decline in pre-tax profits.[5] In the next chapter, we will discuss exchange rates in more detail.

Consumer tastes

International trade is not based solely on price; some people will pay more for a product even though they can buy something similar for less money. This willingness to pay more may be based on prestige, perceived quality or a host of other physical and psychological reasons. Personal tastes dictate consumer decisions.

INTERNATIONAL BUSINESS STRATEGY IN ACTION

Microsoft shows the world is not flat

The dispute between Microsoft and the European Commission demonstrates that the world is not flat. Microsoft is a company that has ridden the wave of worldwide internet access and software applications. Yet, it has run into a brick wall in Brussels. There the EU Directorate General for Competition and State Aid (DG Comp) has imposed large fines for breaking its competition rules.

In March 2004, the DG Comp ruled that Microsoft is abusing its dominant market position with its Windows operating system. Since then the DG Comp has been threatening to impose large daily fines because it says Microsoft is failing to comply with that ruling. On 17 September 2007, Microsoft lost an appeal to the European Court of First Instance ending a nine-year battle with the EU. It paid fines to the EU of $1.4 billion. In December 2007, the EU launched a new antitrust investigation against Microsoft after Norway’s Opera complained about its web browser. In January 2009, the EU Commission accused Microsoft of illegally tying Internet Explorer to Windows. The Commission’s concern was that the US computer giant may have broken competition rules by bundling its web browser with its dominant Windows operating system. Internet Explorer is used by more than half of global business users, with Mozilla’s Firefox at about 32 per cent and Norway’s Opera at 2 per cent. In July 2009, Microsoft reached an agreement with EU antitrust regulators to allow European users a choice of web browsers. The accord ended 10 years of dispute between the two sides. Over that time, the EU imposed fines totalling €1.68 billion (US$2.44 billion, £1.5 billion). The European Commission said Microsoft’s legally binding agreement ended the dispute and averted a possible fine for the company.

This case illustrates that even the world’s most successful internet-based software company does not have unrestricted global market access for its products. Instead, the world is divided into a ‘triad’ with strong barriers to entry into the key regional markets of the EU, North America and Asia–Pacific. Microsoft is simply the latest large MNE to misread the world marketplace. Today, business activity is organised mainly within each region of the triad, not globally. For US firms, the process of going to a foreign triad market in Europe and Asia is fraught with peril.

The world's 500 largest firms, on average, sell 72 per cent of their goods and services in their home region. Very few firms are truly global, defined as selling a significant percentage of their products in each triad region. For example, the world's largest firm, Walmart, generated $500.3 billion in revenue in 2018 and despite operating in 28 countries has almost 80 per cent of its sales and approximately 70 per cent of its assets in the United States alone. Microsoft discloses the geographic dispersion of its sales by geographic segments: sales in the United States and sales outside the United States. Over five years' average 2006–10 and 2014–18 Microsoft generated 60 per cent and 50 per cent of its sales in the United States respectively. In 2018, Microsoft generated approximately 50 per cent of its sales in the United Sates. In terms of products, approximately 50 per cent of total sales were from office products, server products and cloud services (see Table 6.2). If sales in Canada and Mexico are added on top of US sales, it is clear that the majority of its sales are in North America (see Figure 6.2). Firms like Walmart and Microsoft need to understand that a business model developed for North America will need to be adapted when going to Europe and Asia.

In the case of Microsoft, the key difference is in the way that the EU regulatory system operates. In Europe competition policy can be used as a barrier to entry. EU antitrust regulations have traditionally proven stricter than American ones. An individual firm (in this case, Sun Microsystems and Opera) can signal an EU-wide investigation. In this process the deck is stacked against the foreign firm. In 2001 the US firm General Electric also made a similar mistake in its planned acquisition of Honeywell which was disallowed by the EU.

While the United States has somewhat similar antitrust provisions, the application of these is more business friendly than in Europe. US antitrust policy aims to help consumers, whereas EU law helps competitors. Microsoft was able to settle its antitrust case with the Bush administration, but it failed to do so with the EU. The regulatory climate in Europe is harsher than in North America. Multinational firms like Microsoft, which assume free trade, worldwide market entry and other aspects of flat earth thinking, are learning expensive lessons. In addition to differences in regulatory standards across the triad, there are major cultural, social and political differences that deny globalisation.

Table 6.2 Microsoft's revenue classified by product and service offerings in 2018 (millions of US$)

Products and Services	Revenue
Office products and cloud services	28,316
Server products and cloud services	26,129
Windows	19,518
Gaming	10,353
Search advertising	7,012
Enterprise Services	5,846
Devices	5,134
LinkedIn	5,259
Other	2,793
Total	110,360

Source: Microsoft Annual Report 2018.

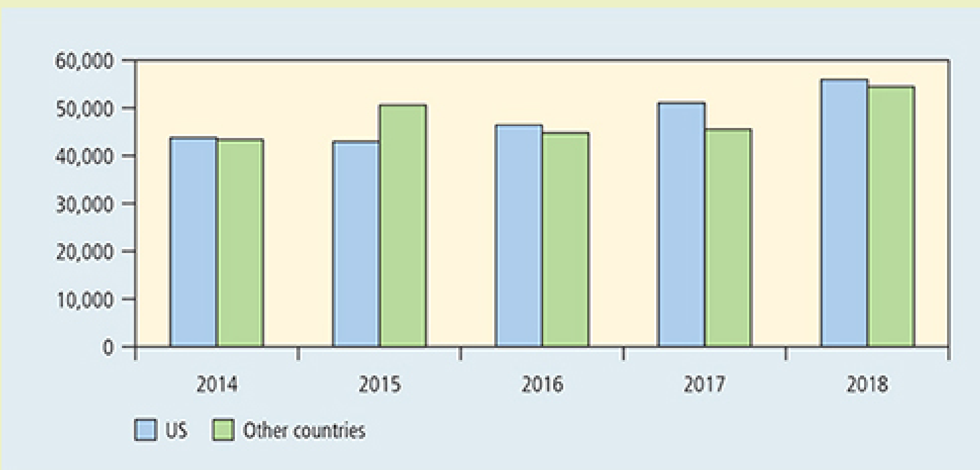

Figure 6.2 Microsoft: revenues by geographic segment (millions of US$, 2014–18)

Source: Microsoft Annual Report 2018.

In terms of regulatory differences, antitrust is but one of an array of market-entry barriers. Even worse are anti-dumping and countervailing duty laws which are used to keep out foreign rivals. The United States itself administers its anti-dumping and countervailing duty laws in favour of the home team. While the US system is transparent, but subject to intense lobbying by large firms with armies of lawyers, the EU investigation of unfair trade law cases, as well as antitrust, can be opaque and self-serving. The EU bureaucrats have continued the case against Microsoft even after

Sun Microsystems and other business rivals in Europe, like Novell and RealNetworks, have settled their disputes. So now we can see the EU, as an institution, fighting a foreign multinational – not exactly a flat world.

The lessons of the Microsoft case are the following. First, globalisation is partly a myth; world business is conducted mainly on an intra-regional basis within each part of the triad. Second, it is unlikely that the regulatory standards across the triad will be harmonised; thus, multinationals must be prepared to adapt their business models when they enter foreign regions of the triad. Third, even in high-tech areas such as software internet applications, the technology itself does not guarantee the flat promise of worldwide market access. The world is not flat; rather, there are very strong regional fault lines.

Sources: Indiana University CIBER Director's Message, 1 May 2006; *Financial Times*, 18 September 2007; *Wall Street Journal*, 18 September 2007; *Financial Times*, 15 January 2008; 'EU fines Microsoft record 1.4 billion', *BBC News*, 27 February 2008; 'Microsoft ends 10 year fight with Europe on browser', *BBC News*, 16 December 2009; 'Microsoft in new EU browser offer', *BBC News*, July 2009; Microsoft, *Annual Reports*, 2006–18.

BARRIERS TO TRADE

Why do many countries produce goods and services that could be purchased more cheaply from others? One reason is trade barriers, which effectively raise the cost of these goods and make them more expensive to local buyers.

Reasons for trade barriers

One of the most common reasons for the creation of trade barriers is to encourage local production by making it more difficult for foreign firms to compete there. Another reason is to help local firms export and thus build worldwide market share by doing such things as providing them with subsidies in the form of tax breaks and low-interest loans. Other common reasons include:

- to protect local jobs by shielding home-country business from foreign competition;
- to encourage local production to replace imports;
- to protect infant industries that are just getting started;
- to reduce reliance on foreign suppliers;
- to encourage local and foreign direct investment;
- to reduce balance of payments problems;
- to promote export activity;
- to prevent foreign firms from *dumping* (selling goods below cost in order to achieve market share);
- to promote political objectives such as refusing to trade with countries that practise apartheid or deny civil liberties to their citizens.

Commonly used barriers

A variety of trade barriers deter the free flow of international goods and services. The following presents five of the most commonly used barriers.

Active learning check

Review your answer to Active Learning Case question 2 and make any changes you like. Then compare your answer to the one below.

2 What reasons were given for the start and subsequent escalation of the US–China trade war in 2017–18?

President Donald Trump started the US–China trade war before he became US President and arguably used it as a platform for his election. His administration based their policy on the alleged barriers to entry for US firms in China and the 'dumping' of Chinese goods into the US, evidenced by the trade imbalance (the US importing far more from China than it exported to China) and intellectual property rights violations. Escalation of the war, with a growing number of imports subject to tariffs in both countries, was driven by reactive retaliations on both sides, with the Trump administration looking to gain popularity by protecting US manufacturing firms and jobs and prompting American consumers to buy American products. The Chinese responded with smaller measures in order to stand up to American 'bullying' without wanting to damage its significant trade advantage.

Price-based barriers

Imported goods and services sometimes have a tariff added to their price. Quite often this is based on the value of the goods. For example, some tobacco products coming into the United States carry an ad valorem tariff (see below) of over 100 per cent, thus more than doubling their cost to US consumers. Tariffs raise revenues for the government, discourage imports, and make local goods more attractive.

Quantity limits

Quantity limits, often known as **quotas**, restrict the number of units that can be imported or the market share that is permitted. If the quota is set at zero, as in the case of Cuban cigars from Havana to the United States, it is called an **embargo**. If the annual quota is set at 1 million units, no more than this number can be imported during one year; once it is reached, all additional imports are turned back. In some cases a quota is established in terms of market share.

International price fixing

Sometimes a host of international firms will fix prices or quantities sold in an effort to control price. This is known as a **cartel**. A well-known example is the Organization of the Petroleum Exporting Countries (OPEC), which consists of Saudi Arabia, Kuwait, Iran, Iraq and Venezuela, among others (see Table 6.3). By controlling the supply of oil it provides, OPEC seeks to control both price and profit.[6] This practice is illegal in the United States and Europe, but the basic idea of allowing competitors to cooperate for the purpose of meeting international competition is being endorsed more frequently in countries such as the United States. For example, US computer firms have now created partnerships for joint research and development efforts.

Financial limits

There are a number of different financial limits. One of the most common is **exchange controls**, which restrict the flow of currency. A common exchange control is to limit the currency that can be taken out of the country: for example, travellers may take up to only $3,000 per person out of the country. Another example is the use of fixed exchange rates that are quite favourable to the country. For example, dollars may be exchanged for local currency on a 1:1 basis; without exchange controls, the rate would be 1:4.

These cases are particularly evident where a black market exists for foreign currency that offers an exchange rate much different from the fixed rate.

Table 6.3 OPEC exports 2017 (millions of US$)

Algeria	39,312
Angola	34,471
Congo	-
Ecuador	21,559
Equatorial Guinea	5,659
Gabon	5,477
Iran	110,764
Iraq	63,314
Kuwait	55,338
Libya	18,379
Nigeria	46,680
Saudi Arabia	231,485
UAE	313,504
Venezuela	32,075
Total	978,017

Source: Adapted from www.opec.org.

Foreign investment controls

Foreign investment controls are limits on foreign direct investment or the transfer or remittance of funds. These controls can take a number of different forms, including: (1) requiring foreign investors to take a minority ownership position (49 per cent or less); (2) limiting profit remittance (such as to 15 per cent of accumulated capital per year); and (3) prohibiting royalty payments to parent companies, thus stopping the latter from taking out capital.

Such barriers can greatly restrict international trade and investment. However, it must be realised that they are created for what governments

believe are very important reasons. A close look at one of these, tariffs, helps to make this clearer.

Tariffs

A **tariff** is a tax on goods that are shipped internationally. The most common is the **import tariff**, which is levied on goods shipped into a country. Less common is the **export tariff** for goods sent out of the country, or a **transit tariff** for goods passing through the country. These taxes are levied on a number of bases. A **specific duty** is a tariff based on units, such as $1 for each item shipped into the country. So a manufacturer shipping in 1,000 pairs of shoes would pay a specific duty of $1,000. An **ad valorem duty** is a tariff based on a percentage of the value of the item, so a watch valued at $25 and carrying a 10 per cent duty would have a tariff of $2.50. A **compound duty** is a tariff consisting of both a specific and an ad valorem duty, so a suit of clothes valued at $80 that carries a specific duty of $3 and an ad valorem duty of 5 per cent would have a compound duty of $7.

Governments typically use tariffs to raise revenue and/or to protect local industry. At the same time, these taxes decrease demand for the respective product while raising the price to the buyer. This is illustrated in Figure 6.3, which shows how the quantity demanded declines from Q_1 to Q_2 when a tariff drives the price of a good from P_1 to P_2 (the world price plus the tariff). This price increase allows local producers to sell Q_3Q_2 and thus take market share away from foreign firms that were exporting Q_3Q_1 into the country. However, the figure shows this is done at the price of charging the consumer more money *and* reducing the number of buyers who purchase the product. At new price P_2 there are no longer any imports.

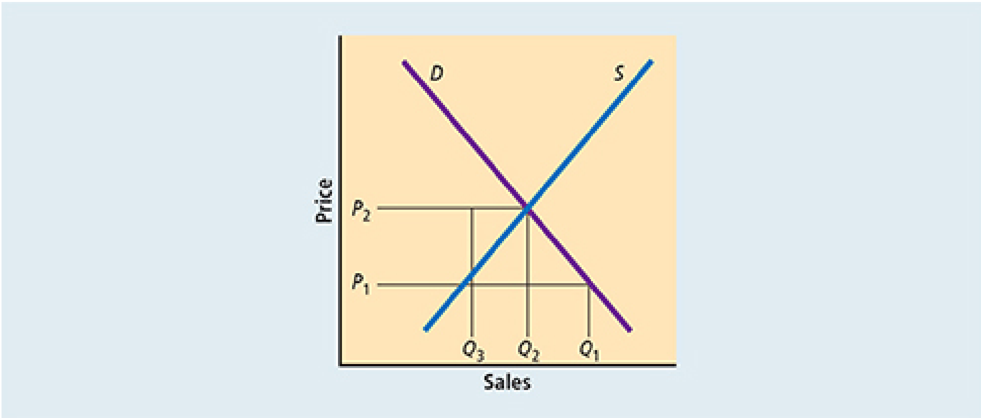

Figure 6.3 Impacts of a tariff

Source: Raymond Vernon and Louis T. Wells, Jr., *The Manager in the International Economy* (Englewood Cliffs, NJ: Prentice Hall, 1991), p. 85.

There are numerous reasons for using tariffs, such as to protect domestic industries or firms. The **Active Learning Case: The US–China Trade War** describes many of these. One of the alleged practices that triggered the US policy was **dumping**, which is the selling of imported goods at a price below cost or below that in the home country. In this case the US administration Kodak argued that the Chinese were selling a range of products below cost price to break into and then dominate the US domestic market.

INTERNATIONAL BUSINESS STRATEGY IN ACTION

Brexit: A sharp lesson in the importance of trade interdependencies

Brexit, the UK exit from the European Community (EU) triggered by the public vote in 2016 (see the overview in Chapter 4), made many people suddenly very aware of both the complexity of international trade agreements and how fundamental they are to businesses and consumers every day. Two major trade issues became apparent after the vote, as policy analysts began to examine the complex set of agreements which had evolved over the decades that the UK was a member of the EU trading block. First, ending these agreements suddenly, particularly through a 'hard' or 'no deal' Brexit, would add significant costs to businesses and increase prices for consumers. Second, some sub-national regions would be harder-hit than others, because of their local economic reliance on UK–EU trade. The impacts of Brexit would not be evenly distributed.

In 2017, 44 per cent of UK exports went to EU countries and 53 per cent of UK imports came from the EU. As an EU member the UK was part of about 40 trade deals and customs agreements with 70 non-EU countries. Without a trade deal post-Brexit, British exporters might be made to operate under WTO (World Trade Organisation) rules with goods and services being subject to the same tariff barriers as all other non-EU countries. The EU maximum tariff on cars at that time, for example, was 10 per cent and on some kinds of clothing it was 12 per cent, while on beef it was 12.8 per cent plus over $250 per 100kg (agricultural tariffs can be complicated). For physical products, customs delays would add to these extra tariff costs. One calculation suggested that a two-minute delay at the port of Dover, to complete the more complex customs procedures, would create a 17-mile traffic jam on the M20. Such barriers would also make just-in-time production systems impossible, creating the risk that automotive firms, for example, would need to move manufacturing plants out of the UK and into Europe (see Chapter 16, **Active Learning Case: Brexit troubles for Jaguar Land Rover**). Added cost would reduce competitiveness and increase prices, particularly for food and basic products, with a greater impact on lower-income households.

The UK's trading partners would be affected in different ways. Germany had a significant trade surplus, selling around $25 billion more to the UK than they imported from the UK in 2017.

Ireland on the other hand imported around $16 billion more than it exported to the UK. But within countries, different regions have different economic structures depending on the firms and industries that they host. This means that some UK regions were much more at risk from a hard Brexit because of the volume of trade they had with EU counterparts. For those UK regions with a strong reliance on manufacturing industries and locked into global production chains across Europe, Brexit presented a major challenge to local economic security. Research at City-REDI in the University of Birmingham showed that Northern Ireland, the North-East and the West Midlands were most exposed and ironically these were regions with a large majority voting to leave the EU. These were also among the lower-income, lower-skilled and less-productive areas of the UK, where social inequalities were both the cause, and the result, of economic weaknesses.

Debate over Brexit encompasses political, economic and social factors. As with most economic shocks the weaker, poorer, low-skilled, high-unemployment communities are hit hardest. During the Brexit negotiations they also seemed to be furthest from the minds of the central government in London, who were more concerned with political rivalry than the economic realities of taking the UK out of the EU. For policy-makers, managers and the general public, Brexit was a sharp reminder of the importance of understanding how dependent we are on international trade and the institutional and legal structures that determine the rules under which we trade.

Websites: www.ukandeu.ac.uk/; https://www.birmingham.ac.uk/schools/business/research/research-projects/city-redi/economic-impacts-of-brexit-on-the-uk.aspx; https://researchbriefings.files.parliament.uk/documents/CBP-7851/CBP-7851.pdf; https://theconversation.com/how-brexit-will-hit-different-uk-regions-and-industries-91287

Sources: Bailey, D., McCann, P. and Ortega-Argiles, R. (2018) 'Could Brexit spell the end for "just-in-time" production?' *Prospect Magazine*; Ortega-Argiles, R. et al. (2018) 'How Brexit will hit different UK regions and industries', *The Conversation* UK, 9 February; Collinson, S. (2017) 'The declining relevance and legitimacy of IB scholarship in a world that really needs it', *Academy of International Business INSIGHTS*, vol. 17, no. 2: p. 711. Ghemawat, P. (2016) 'Beyond Brexit: an initial analysis and questions for the AIB community', *Academy of International Business*

INSIGHTS, vol. 16, no. 3, pp. 3–6. Los, B., Chen, W., McCann, P. and Ortega-Argiles, R. (2017) 'An assessment of Brexit risks for 54 industries: most services industries are also exposed', *City-REDI Policy Briefing series*, December 2017.

1. What trade-related issues were highlighted by Brexit?
2. How did EU membership provide the UK with more certainty regarding international trade?
3. What were the trade-related costs and benefits to the UK of leaving the EU?
4. Why do changes in international trade agreements affect some sub-national regions more than others?

Another reason for using tariffs is to raise government revenue. Import tariffs, for example, are a major source of revenue for less developed countries. A third reason is to reduce citizens' foreign expenditures in order to improve the country's balance of payments.

Tariffs continue to be one of the most commonly used barriers to trade, despite the fact that they often hurt low-income consumers and have a limited impact, if any, on upper-income purchasers. In recent years most industrialised countries have tried to reduce or eliminate the use of these trade barriers and to promote more free trade policies. The United States is a good example. (The trade policies of the EU are discussed in Chapter 16 and those of Japan in Chapter 17.)

Active learning check

Review your answer to Active Learning Case question 3 and make any changes you like. Then compare your answer to the one below.

3 **How can trade barriers negatively affect third-countries who are not directly targeted in a trade war?**

Any country exporting products and services can be affected by general tariff barriers introduced to target one specific country, unless these are applied exclusively to imports from that country. These will add to the costs (and reduce competitiveness) of all foreign imports in a specific industry. Also, global value chains span many countries, exposing international firms in these countries to changes in the costs of imports and exports triggered by the introduction of tariff and non-tariff barriers anywhere along these value chains. So, for example, when the US applied tariffs to Chinese imports in particular sectors, other Asian countries who sold components to Chinese manufacturers in these sectors were affected.

NON-TARIFF BARRIERS TO TRADE

Non-tariff barriers are rules, regulations and bureaucratic red tape that delay or preclude the purchase of foreign goods. Examples include (1) slow processing of import permits; (2) the establishment of quality standards that exclude foreign producers; and (3) a 'buy local' policy. These barriers limit imports and protect domestic sales.

The economic effects of non-tariff barriers (NTBs) on trade are roughly similar to those of tariffs. They are inefficient distortions that reduce potential gains from trade. Table 6.4 lists a wide range of NTBs.

NTBs have gained prominence and importance in recent years as nations have begun resorting to them more frequently for protection. Sometimes they are not imposed by countries to interfere deliberately with trade.[7] Rather, they arise out of domestic policy and economic management. Examples include tax breaks to reduce regional income disparities or regulations designed to increase local purchasing or employment. These, in turn, result in a type of indirect export subsidy. Other NTBs are more blatant devices that restrict imports or foster exports.

Table 6.4 Common non-tariff barriers to trade

Specific limitation	Customs administrative rules	Government participation	Import charges
Quotas (including voluntary)	Valuation systems	Procurement policies	Import deposits
Import licenses	Anti-dumping rules	Export subsidies and incentives	Supplementary duties
Supplementary incentives	Tariff classifications	Countervailing duties	Import credits
Minimum import limits	Documentation needed	Domestic assistance programmes	Variable levies
Embargoes	Fees	Trade diverting	Border levies
Sectoral bilateral agreements	Disparities in quality and testing standards		
Orderly marketing agreements	Packaging, labelling, and marketing standards		

Quotas

The most important NTBs are quotas that restrict imports to a particular level.[8] When a quota is imposed, domestic production generally increases and prices rise. As a result, the government usually ends up losing tariff revenues.

Historically, the GATT and WTO have prohibited import quotas except on agricultural products, as emergency measures, or when a country has short-run balance of payments problems. Countries have circumvented this regulation most notably for textiles, footwear and automobiles by negotiating voluntary export restraint agreements that are useful in preventing retaliatory action by the importing country. In general, business would rather be protected by quotas than by tariffs. Under quotas, if future domestic demand is known, companies can determine their future production levels. Under tariffs, domestic producers must estimate the elasticity of the demand curve for imported products and the future movements in world prices, which is a more difficult challenge.

'Buy national' restrictions

'Buy national' regulations require governments to give preference to domestic producers, sometimes to the complete exclusion of foreign firms. In Europe, for example, many of the telephone, telegraph, electric utility, airline, and railroad industries are government owned and buy from national firms only, thus closing a large market to exporters. On the other hand, countries like the United States have a similarly wide range of inefficient 'Buy American' regulations at the national and state levels that discriminate against foreign suppliers. In 1976 the Tokyo Round of GATT discussions started a process that led to the Agreement on Government Procurement (GPA). In 2014 a total of 17 parties signed up to the revised version of the agreement, comprising 45 WTO members. Since 2014, Montenegro, New Zealand, Ukraine and Moldova have signed up to the GPA. The central aim of the GPA is to open up government procurement markets (worth an estimated US$1.7 trillion annually) to all members.[9]

Customs valuation

Considerable progress has been made in the area of customs valuation for the payment of duties. Value for duty is now generally based on the invoice cost, and the latitude of any country's customs office to reclassify products has been reduced.

Technical barriers

Product and process standards for health, welfare, safety, quality, size and measurements can create trade barriers by excluding products that do not meet them. Testing and certification procedures, such as testing only in the importing country and conducting on-site plant inspections, are cumbersome, time consuming and expensive. The costs must be borne by

the exporter prior to the foreign sale. National governments have the right and duty to protect their citizens by setting standards to prevent the sale of hazardous products. But such standards can also be used to impede trade. For example, at one point Japan excluded US-made baseball bats from the market because they did not meet the country's standard. No product produced outside Japan (even products made by foreign subsidiaries of Japanese MNEs) could bear the certification stamp of the Japanese Industrial Standard (JIS) or the Japanese Agricultural Standard (JAS), and selling in Japan without the JIS or JAS logo was difficult. Similarly, at one time the regulations for automobile safety in the United States required that bumpers be above the height practical for imported subcompact cars, thus creating a technical barrier for these car manufacturers.

Anti-dumping legislation, subsidies and countervailing duties

The GATT and WTO allow importing countries to protect their producers from unfair competition, such as 'dumping' goods at extremely low prices in an effort to gain market share and to drive out local competition. Importing countries are allowed to impose additional duties on products that have received export subsidies or are 'dumped'. Before the duties are imposed, however, the country must show that its domestic industry has suffered 'material' injury from dumped or subsidised imports. Although products at these artificially low prices provide consumers in the importing country with a 'good buy', such competition is thought to be unfair to domestic producers, who object to dumping (and also to subsidised imports that can be offset by 'countervailing' duties) if the domestic market of the exporting country is closed to them. A good example is the US auto industry, which claims that some Japanese cars are cheaper in the US market than at home, while Japan continues to impede exports of US cars into Japan.

The WTO has developed a code on countervailing duties and anti-dumping duties that now expedites the process of determining whether exports have been dumped or subsidised and whether the domestic industry has been injured. This subject is exceedingly complex. Here are some examples (and answers):

- If the EU remits value-added taxes on exports by EU producers, is this a subsidy? (*No*)
- If Canada subsidises production in a specific sector in one of its depressed regions for domestic purposes, are the exports of a subsidised firm subject to countervailing action? (*Yes*)
- If the British government subsidises the British steel industry and its losses incurred by selling at home and abroad at prices below full cost, are its exports subject to anti-dumping or to countervailing duties? (*Maybe, sometimes*)

The problem is complex because of the difficulty in determining what material injury is and how it should be measured. This area is likely to be a point of contention for years to come.

Agricultural products

Trade in agricultural products is highly regulated by both quotas and fixed and variable tariffs. Domestic producers in most industrialised countries are often highly subsidised both directly and by artificially high domestic prices. Agricultural exports are often subsidised as well and, for example, the EU has strongly resisted changes to its Common Agricultural Policy (CAP) for some time. The CAP sets variable tariffs on imports to maintain high domestic prices by excluding or impeding imports. Major reforms in the CAP are now underway that will see continuing support for farmers but independently of production volumes. This is expected to improve the EU's

negotiating position at the WTO. The United States is not without guilt in this area, however, since it also subsidises the export of many agricultural products. The countries most affected by these subsidies are less developed countries with abundant and inexpensive labour and land, and thus a competitive advantage in agricultural products. Agricultural subsidies have often stalled trade talks as these countries refused to further liberalise while developed countries continued to subsidise agriculture.

Export restraints

Over the vigorous objections of countries exporting natural resources, the GATT (and WTO) rounds have moved to tighten the conditions under which exports can be restrained. In general, world tariffs increase with the level of processing: for example, import duties increase as copper is processed from concentrate to blister, to refined copper, to copper wire and bars, to copper pots and pans. This tariff structure makes upgrading of natural resources in the producing country difficult. Natural resource-producing countries have been largely unsuccessful in their attempts to harmonise tariffs on a sectoral basis in order to increase their ability to upgrade prior to export. However, they have argued successfully for their right to restrict exports to induce further domestic processing.

OTHER ECONOMIC DEVELOPMENTS

In addition to the above, other economic developments warrant consideration. These include countertrade, trade in services and free trade zones.

Countertrade

Countertrade is essentially barter trade in which the exporting firm receives payment in terms of products from the importing country. Countertrade is important to the airline industry (for example, the purchase of Boeing airplanes by British Airways if Boeing uses Rolls-Royce engines) and in defence (for example, the purchase of US jet fighters by Canada if some of the parts are locally sourced in Canada). Barter sometimes takes the form of a buyback in which the exporter agrees to take products that are locally produced.

Countertrade tends to decrease the efficiency of world trade because it substitutes barter for the exchange of goods by the price system. For example, a US exporter of machinery to Indonesia may have to take payment in an 'equivalent value' of palm oil or rattan. The exporting firm will then have to either sell these products, in which it has no expertise, itself, or sell them through a broker or other firm. Some party to the trade – exporter, importer or consumer – must bear these additional costs. Despite such obvious inefficiencies, countertrade appears likely to continue as an increasingly important factor in the international trade environment of the twenty-first century.

In one type of situation, however, countertrade may be beneficial. For example, if a US producer of textile machinery exports to China and agrees

to take payment in the form of textile products, importers in the United States may perceive a lower risk of variability in product quality and delivery schedules (as a result of US technology and management), and the Chinese may perceive a lower risk of product failure in buying the machinery, since the selling firm will not be 'paid' unless the machinery performs to specifications.

Trade in services

As high-income countries have moved towards a service economy, trade in services has grown and become a significant component of the current accounts of many countries. In advanced countries like the US and the UK, for example, a long-running trade surplus in services (higher exports than imports) has provided a counterbalance to the trade deficit in goods (imports exceed exports). Figure 6.4 shows the main deficit and surplus components of the US current account balance. (The balance of payments account will be explained in the Appendix to this chapter.)

The flow of services across/among countries is highly regulated. Internationally traded services such as banking, investment income, insurance, media, transportation, advertising, accounting, travel and technology licensing are subject to a host of national and international regulations for economic, social, cultural and political reasons. The General Agreement on Trade in Services (GATS) covers all services except those provided by the government and those related to air traffic. Member countries are not forced to open all their service industries but can choose those areas for which they want to guarantee access to foreigners and, within a framework, how much access they want to provide. For example, a host nation might limit the scope of a foreign bank's operation through the use of licenses or by setting a maximum number of allowable branches. Whatever forum is used, negotiating reductions in service trade barriers will be

difficult, complex and lengthy. The barriers are often difficult to list, much less quantify for purposes of negotiation. And the issues are often highly charged and not subject to rational analysis.

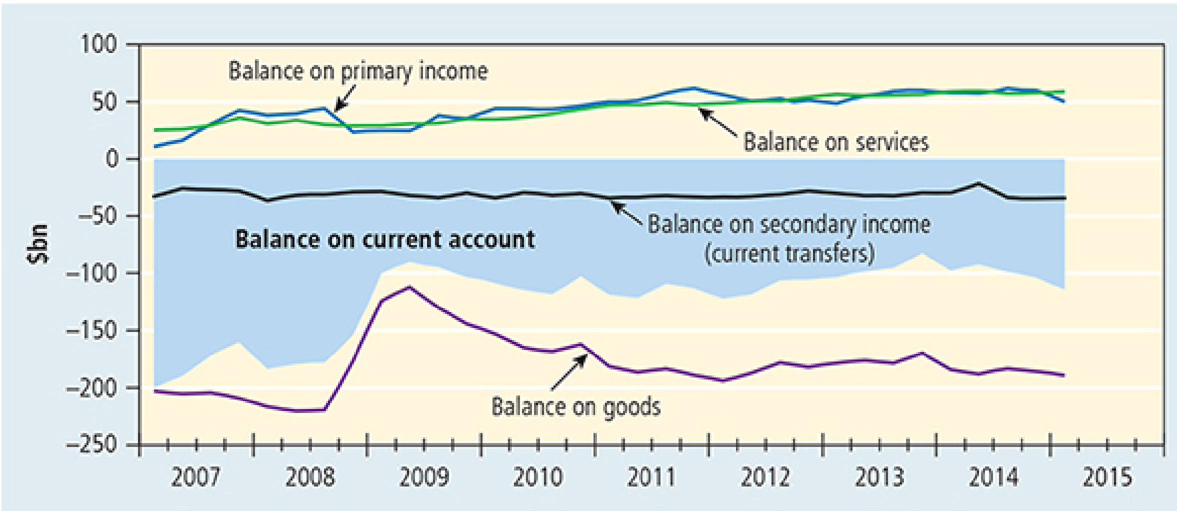

Figure 6.4 The US current account balance and its components, 2007–15

Source: http://blog.bea.gov/tag/current-account-deficit/.

Free trade zones

A **free trade zone** is a designated area where importers can defer payment of customs duty while products are processed further (same as a foreign trade zone). Thus, the free trade zone serves as an 'offshore assembly plant', employing local workers and using local financing for a tax-exempt commercial activity. The economic activity takes place in a restricted area, such as an industrial park, because the land is often being supplied at a subsidised rate by a local host government that is interested in the zone's potential employment benefits.

To be effective, free trade zones must be strategically located either at or near an international port, on major shipping routes, or with easy access to a major airport. Important factors in the location include the availability of utilities, banking and telecom services, and a commercial infrastructure.

More than 400 free trade zones exist in the world today, often encompassing entire cities, such as Hong Kong and Singapore. The advantages offered by free trade zones for private firms include: the firm pays the customs duty (tariff) only when the goods are ready to market; manufacturing costs are lower because no taxes are levied; the manufacturer can repackage the goods, grade them and check for spoilage in the zone.

Before the establishment of more free trade zones becomes fully accepted and encouraged, governments must be convinced of their many economic benefits. Free trade zones are a vital necessity if nations are to remain competitive on an international scale. Not only will existing companies benefit from their use, but new industries will be attracted, keeping up the same benefits of world trade.

The **maquiladora industry** along the US–Mexican border is an excellent example of a free trade zone. The low wage rate in Mexico and the NAFTA make the *maquiladora* region both accessible and important to labour-intensive firms in the United States and Canada. From only 12 *maquiladora* plants in 1965, more than 570 now exist, providing over 100,000 jobs in Tijuana.

No Mexican taxes are paid on goods processed within the *maquiladoras*. Foreign companies doing such processing can benefit from lower wages and land costs than those in the United States as they increase the value added to their products. In return, Mexico attracts FDI into permanent plants, creates jobs and collects taxes on any final products sold to the foreign firms, or within Mexico.

KEY POINTS

1. International economics is the branch of economics concerned with the purchase and sale of foreign goods and services. This includes topics such as international trade, balance of payments and barriers to trade.
2. A number of international trade theories help to explain why nations trade. These include the theory of absolute advantage, the theory of comparative advantage, factor endowment theory, the Leontief paradox and the international product life cycle theory. While no one theory offers a complete explanation of why nations trade, they collectively provide important insights.
3. There are a number of barriers to trade. Some of the most common include tariffs and price-based barriers, quantity limits, international price fixing, non-tariff barriers, financial limits and foreign investment controls.
4. Although tariffs are often introduced to maintain local jobs and assist infant industries, they are inefficient. This economic inefficiency results in higher prices of imported goods for the consumers. The redistribution of resources from more efficient industry further adds to the cost of a tariff. Such costs do not occur under free trade.
5. Non-tariff barriers (NTBs) provide similar economic inefficiencies to tariffs. Unlike tariffs, however, NTBs are usually not imposed by nations to interfere deliberately with trade; they arise out of domestic policy. There are several types of NTBs, including quotas, ‘buy national’ restrictions, technical barriers and export restraints.

6 Countertrade is a form of barter trade in which the exporting firm receives payments in terms of products produced in the importing country. It is most pronounced in East–West trade, and although it may be beneficial to the trading partners, it increases the inefficiencies in the world trade system, which in turn raises costs and decreases trade volume.

7 International trade in services is far larger in value terms than trade in goods. Because the movement of physical products and components is not involved, physical borders are not relevant, but tariff and non-tariff barriers still apply.

8 A free trade zone is a designated area where importers can defer payment of customs duty while further processing of products takes place. In essence, it is an offshore assembly plant. The majority of these areas exist in developing countries and handle approximately 20 per cent of worldwide trade. Free trade zones are advantageous to all because they provide benefits such as increased employment and lower business costs.

Key terms

- **mercantilism**
- **neo-mercantilism**
- **theory of absolute advantage**
- **theory of comparative advantage**
- **factor endowment theory**
- **Heckscher–Ohlin theory**

- **Leontief paradox**
- **international product life cycle (IPLC) theory**
- **monetary exchange rate**
- **quota**
- **embargo**
- **cartel**
- **exchange controls**
- **foreign investment controls**
- **tariff**
- **import tariff**
- **export tariff**
- **transit tariff**
- **specific duty**
- **ad valorem duty**
- **compound duty**
- **dumping**
- **non-tariff barriers**
- **countertrade**
- **free trade zone**
- **maquiladora industry**

REVIEW AND DISCUSSION QUESTIONS

1 Why is it difficult to solve international economic problems in the short run?

2 What is the supposed economic benefit of embracing mercantilism as an international trade theory? Are there many disadvantages to the use of this theory?

3 How is the theory of absolute advantage similar to that of comparative advantage? How is it different?

4 In what way does factor endowment theory help explain why nations trade? How does the Leontief paradox modify this theory?

5 If an innovating country develops a new technologically superior product, how long will it be before the country begins exporting the product? At what point will the country begin importing the product?

6 Of what value is the international product life cycle theory in helping to understand why nations trade?

7 How does each of the following trade barriers work: price-based barriers, quantity limits, international price fixing, non-tariff barriers, financial limits and foreign investment controls?

8 What are some of the reasons for trade barriers? Identify and describe five.

9 How does the United States try to encourage exports? Identify and describe two ways.

10 Non-tariff barriers have become increasingly predominant in recent years. Describe a non-tariff barrier, and list four types, explaining how the United States does or could use such a device.

11 How does countertrade work? Is it an efficient economic concept?

12 What is a free trade zone? Is it an efficient economic concept?

13 What are two future problems and challenges that will have to be addressed by the international monetary system? Describe each.

14 What is meant by the term *balance of payments*?

15 What are the three major accounts in the balance of payments?

16 How would the following transactions be recorded in the IMF balance of payments?

- **a** IBM in New York has sold an $8 million mainframe computer to an insurance company in Singapore and has been paid with a check drawn on a Singapore bank.
- **b** A private investor in San Francisco has received dividends of $80,000 for stock she holds in a British firm.
- **c** The US government has provided $60 million of food and medical supplies for Kurdish refugees in Turkey.
- **d** The Walt Disney Company has invested $50 million in a theme park outside Paris, France.

REAL CASE

China’s Rare Earth Minerals

In the two decades to 2017, China’s share of global merchandise exports almost tripled, rising from 4.7 per cent to 12.8 per cent. However, this trend did not reflect China’s exports of rare earth minerals, which are commonly used in high-tech products. This is a group of 17 minerals, used in a wide range of products such as hybrid cars, weapons, flat-screen TVs, mobile phones, mercury-vapour lights and camera lenses. As the elements associated within these minerals are ‘relatively/moderately abundant’, meaning less common than elements like oxygen, silicon, aluminium and iron (which together account for approximately 90 per cent of the Earth’s crust), they are called ‘rare earth’ minerals.

China’s dominant global position in the production of rare earths took a hit in 2015 as the World Trade Organization (WTO) forced the nation to abolish their restrictive export quotas for rare earth products. Under the guidelines set by the WTO, although sales of rare earth products required an export license, this was no longer associated with fixed quotas. China had previously sought to protect the value of rare earths by imposing export quotas in 2009, but the rise in computer and high-tech products fuelled supply concerns and quickly prompted other nations to start producing rare earth products to take advantage of this market opportunity. As such, the US was quick to open and develop new mines in search of rare earth minerals and a number of countries, including Japan, started to invest in initiatives to recycle rare earths.

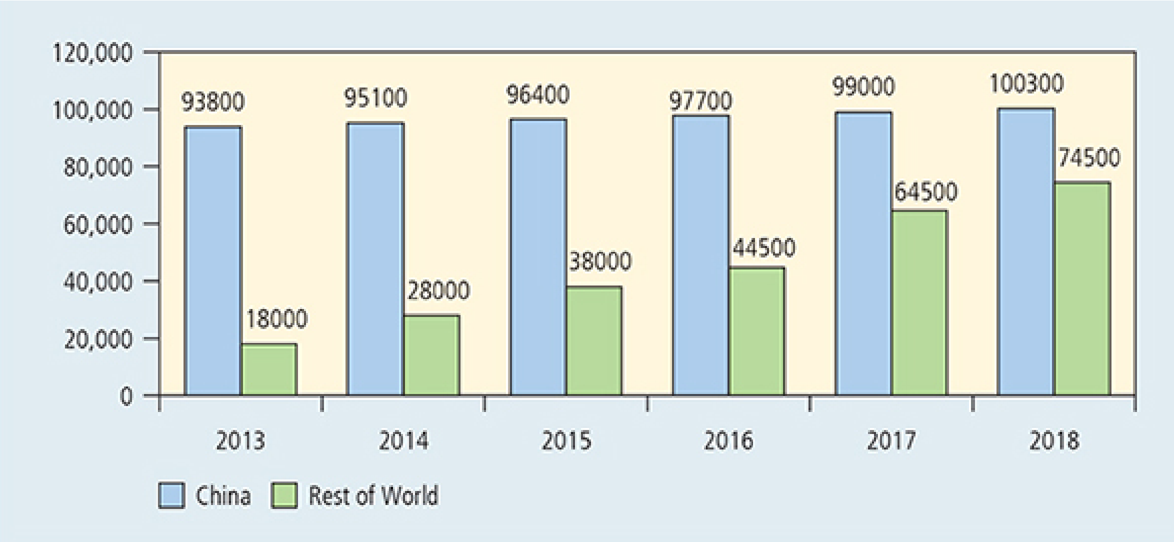

Figure 6.5 **Rare earth mineral production: China versus rest of the world (metric tonnes)**

Note: 2018 refer to projected figures

Source: https://www.statista.com/statistics/279953/rare-earth-production-in-china-and-outside/.

A primary reason for China to impose quotas on rare earth mineral exports was a trade dispute with Japan. Japanese multinationals who required high volumes of rare earth minerals, such as Hitachi and Mitsubishi, started to re-design some of their products to reduce reliance on these mineral components. Although China's imposition of quotas provided it with market power and political leverage, the state struggled to exploit their position over the long run as the rest of the world picked up the slack and broadening the global supplier base of these minerals (Figure 6.5).

When other nations, and multinationals, started to invest in the production of rare earth minerals, Beijing was quick to claim that there was a need to conserve a scarce resource and limit environmental damage that could be caused by opening new mining sites. However, China did not impose restrictions on either the production or use of rare earths by firms within the domestic market. Initially, China's 2009 quota was challenged by the US in 2012 via the WTO and the EU and Japan were quick to join forces with the US's complaint. Historically, up until the late 1990s the US produced and supplied their own rare earth minerals, but production declined as low-cost Chinese firms started to dominate the global market, and China decided to take control of the rare earth market by forcing Chinese firms to merge into state-owned groups. The export quota that was

placed by China in 2009 came at an economically sensitive period, as following the 2008 financial crisis many nations were seeking to boost exports to tackle unemployment concerns.

The Chinese dominated global markets in 2013 when they produced almost 80 per cent of rare earth minerals. This declined to reach 40 per cent by 2018. In an attempt to take back some control over the market and push up prices, China decided to limit the total production of rare earth minerals in the second half of 2018. A production limit of 45,000 tonnes was set, representing a five-year low. Given the recent US and China trade war, arguably this was an indirect blow aimed at the US, as 45,000 tonnes of rare earths is only enough to supply China's domestic market needs. There were indications that this attempt to take back some control of the market was working. The price for one key rare earth mineral, PrNd Oxide, began to rise in 2019. But the evidence overall is mixed with some rare earth minerals showing price increases and others showing declines.

Overall, history tells us that when the supply for essential materials and components like rare earth minerals becomes too heavily dependent on one country, in this case China, other nations mobilise to rebalance the market. The dynamics of international trade are driven by actions and reactions, as nations seek to gain temporary local advantage over others through trade policy, or defend local interests against the policies of others.

Sources: https://www.theguardian.com/world/2015/jan/05/china-scraps-quotas-rare-earth-wto-complaint; https://www.bbc.co.uk/news/business-30678227 http://stat.wto.org/CountryProfile/WSDBCountryPFView.aspx?Country=CN; https://www.reuters.com/article/us-china-rareearths/china-cutting-rare-earth-output-unnerving-global-manufacturers-idUSKCN1MY2GZ.

1 Does the theory of comparative advantage apply to China's trade with industrialised countries? How?

2 How does factor endowment theory apply to China's trade with industrialised countries?

3 Will China continue to dominate in the production and supply of rare earth minerals?

REAL CASE

Dumping on trade complaints

One of the biggest complications in international trade is the ability of domestic producers to lobby their home governments to erect barriers to trade. This varies country by country in terms of the legal frameworks that determine how and to what extent this is allowed and in terms of its impact on trade agreements. Global trade agreements also limit how far individual countries can apply local protectionist measures. In the past, the textile, apparel, and shoe industries, for example, were able to obtain protection from cheaper imports through tariffs, quotas and special measures. Now multilateral trade agreements under the GATT and WTO (and also regional and bilateral agreements such as NAFTA and the emerging Asian Pacific Economic Cooperation forum) outlaw these instruments of protection.

However, to some extent, some of these agreements have been undermined by more subtle approaches to protectionism. Prominent as a new type of protectionist device is the use of ‘unfair trade laws’, especially anti-dumping (AD) and countervailing duty (CVD) actions. The economic logic of AD and CVD makes some sense. It is unfair for a foreign producer to ‘dump’ a product in your country below its price in the home country, or below the cost of producing it. Similarly, subsidised foreign products should be offset by a CVD of equivalent effect. The problem, however, lies with the administration of the trade laws, which is subject to political lobbying.

A variety of studies have found that the bureaucrats who administer AD and CVD laws are subject to capture by the home industries, which then use AD and CVD cases as harassment tools against often economically efficient foreign rival producers. For example, Rugman and Anderson (1987) found that the US administration of AD and CVD was used in a biased manner against Canadian producers, especially in resource-based industries such as softwood lumber, fishing and agriculture. Thus, in the Canadian–US Free Trade Agreement of 1989, and again in NAFTA, five-person binational panels of trade law experts were set up to review the decision of the US (and Canadian) trade law agencies. More recently, in 2019 the US announced its intentions to withdraw from a six-year-old trade agreement with Mexico concerning the trade of tomatoes (see full case study in Chapter 18). This agreement had previously averted a trade war over tomatoes in 2013, by

establishing a floor price for the Mexican product in the United States and stopping US farmers from pursuing anti-dumping charges against Mexican exporters. Some see this as a way for the US to impose new tariffs on such products.

In a subsequent study, Rugman and Anderson (1987) found that these binational panels were able to remand back (i.e., successfully challenge) the decision of the US agencies twice as often in cases involving Canada as in AD and CVD cases involving the rest of the world. In related work researchers have found that the EU is just as bad as the United States when it comes to taking questionable AD measures, especially against Asian countries. Indeed, one of the unresolved problems is how smaller countries can secure access to the protected markets of triad economies such as the United States and the EU. In Japan's case, there are similar arguments (including those from its triad rivals) that it has entry barriers in place preventing market access.

Website: www.wto.org; https://mexiconewsdaily.com/news/us-pulls-out-of-mexico-tomato-agreement/.

Sources: Andrew D. M. Anderson, *Seeking Common Ground: Canada–US Trade Dispute Settlement Policies in the Nineties* (Boulder, CO: Westview Press, 1995); Alan M. Rugman, *Multinational Enterprises and Trade Policy* (Cheltenham: Edward Elgar, 1996); Alan M. Rugman and Andrew D. M. Anderson, *Administered Protection in America* (London and New York: Routledge, 1987); Alan M. Rugman and Andrew D. M. Anderson, 'NAFTA and the dispute settlement mechanisms', *The World Economy*, December 1997, pp. 935–50; Alan M. Rugman and Michael Gestrin, 'EC anti-dumping laws as a barrier to trade', *European Management Journal*, vol. 9, no. 4 (December 1991), pp. 475–82.

1 Why are AD and CVD measures brought and imposed?

2 What is the impact on a firm from a non-triad country if it faces an AD or CVD case in its major market?

3 What is the solution to the abusive use of AD and CVD measures by triad economies?

NOTES

1 Asra Q. Nomani and Douglas Lavin, 'US and Japan nearing accord in trade dispute', *Wall Street Journal*, 10 March 1994, p. A3; and Richard McGregor, 'Beans are on the Beijing menu as Bush prepares to talk trade', FT.com, 21 February, 2002.

2 Also see Steven Greenhouse, 'French shift on state-owned sector', *New York Times*, 8 April 1991, p. C2.

3 E. Więcek-Janka, M. Papierz, K. Martyna and N. Michal (2017). Apple Products: A Discussion of the Product Life Cycle. 2017 International Conference on Management Science and Management Innovation (MSMI 2017).

4 See, for example, Noritsugu Nakanishi (2018) *The Essence of International Trade Theory*, (Kobe University, Japan), World Scientific.

5 'Tested by the mighty euro', Economist.com, 18 May 2004.

6 'Qatar decides to leave OPEC', *The Economist*, December 2018, https://www.economist.com/middle-east-and-africa/2018/12/03/qatar-decides-to-leave-opec

7 Claude Barfield, 'Nerves of steel', *Financial Times*, 1 March 2002.

8 Sometimes these are voluntary quotas, as seen in Andrew Pollack, 'Japan takes a pre-emptive step on auto exports', *New York Times*, 9 January 1993, pp. 17, 26.

9 WTO Agreement of Government Procurement, https://www.wto.org/english/tratop_e/gproc_e/gp_gpa_e.htm, accessed in September 2015.

BIBLIOGRAPHY

Anderson, Andrew D. M. *Seeking Common Ground: Canada–US Trade Disputes* (Boulder, CO: Westview Press, 1995).

Baggs, Jen and Brander, James A. ‘Trade liberalization, profitability, and financial leverage’, *Journal of International Business Studies*, vol. 37, no. 2 (March 2006).

Banalieva, Elitsa R. and Sarathy, Ravi. ‘The impact of regional trade agreements on the global orientation of emerging market multinationals’, *Management International Review*, vol. 50, no. 6 (2010).

Barboza, Gustavo A. and Trejos, Sandra R. ‘Empirical evidence on trade reform, revealed trade openness, and output growth in Latin America: how far have we come?’ *Multinational Business Review*, vol. 16, no. 4 (2008).

Beleska-Spasova, Elena and Glaister, Keith W. ‘The geography of British exports: country-level versus firm-level evidence’, *European Management Journal*, vol. 27 (2009).

Beleska-Spasova, Elena and Glaister, Keith W. ‘Geographic orientation and performance evidence from British exporters’, *Management International Review*, vol. 50, no. 5 (2010).

Beleska-Spasova, Elena and Glaister, Keith W. ‘The role of firm-specific advantages in UK export initiation’, *Multinational Business Review*, vol. 19, no. 2 (2011).

Bertrand, Olivier. ‘What goes around, comes around: effects of offshore outsourcing on the export performance of firms’, *Journal of International Business Studies*, vol. 42 (2011).

Brewer, Thomas L. and Young, Stephen. ‘Multilateral institutions and policies: their implications for multinational business strategy’, in Alan M. Rugman (ed.), *The Oxford Handbook of International Business*, 2nd ed. (Oxford: Oxford University Press, 2009).

Buckley, Peter J. ‘Government policy responses to strategic rent seeking transnational corporations’, *Transnational Corporations*, vol. 5, no. 2 (August 1996).

Chakravarty, Dwarka, Hsieh, Ying-Ying, Schotter Andreas P.J. and Beamish, Paul W. ‘Multinational enterprise regional management centres: Characteristics and performance’, *Journal of World Business*, vol. 52, no. 2 (2017).

Colantone, Italo and Sleuwaegen, Leo. ‘International trade, exit and entry: a cross-country and industry analysis’, *Journal of International Business Studies*, vol. 41, no. 7 (2010).

Collie, David R. and Le, Vo Phuong Mai. ‘Antidumping regulations: anti-competitive and anti-export’, *Review of International Economics*, vol. 18, no. 5 (2010).

Curran, Louise and Zignago, Soledad. ‘Intermediate products and the regionalization of trade’, *Multinational Business Review*, vol. 19, no. 1 (2011).

Davis, Lucy. ‘Ten years of anti-dumping in the EU: economic and political targeting’, *Global Trade and Customs Journal*, vol. 4, no. 7 (2009).

Dunning, John H. and Mucchielli, Jean-Louis (eds.). *Multinational Firms: The Global-Local Dilemma* (London: Routledge, 2002).

Fratianni, Michele U., Marchionne, Francesco and Oh, Chang H. ‘A commentary on the gravity equation in international business research’, *Multinational Business Review*, vol. 19, no. 1 (2011).

Fratianni, Michele U. and Oh, Chang H. ‘Expanding RTAs, trade flows, and the multinational enterprise’, *Journal of International Business*

Studies, vol. 40 (2009).

Fung, Hung-Gay, Yau, Jot and Zhang, Gaiyan. 'Reported trade figure discrepancy, regulatory arbitrage, and round-tripping: evidence from the China–Hong Kong trade data', *Journal of International Business Studies*, vol. 42 (2011).

Goedhuys, Micheline and Sleuwaegen, Leo. 'International standards certification, institutional voids and exports from developing country firms', *International Business Review*, vol. 25, no. 6 (2016).

Liu, Runjuan, Feils, Dorothee J. and Scholnick, Barry. 'Why are different services outsourced to different countries?' *Journal of International Business Studies*, vol. 42 (May 2011).

Markusen, James R. 'International trade theory and international business', in Alan M. Rugman and Thomas L. Brewer (eds.), *The Oxford Handbook of International Business* (Oxford: Oxford University Press, 2001).

Ostry, Sylvia. *The Post-Cold War Trading System* (Chicago, IL: University of Chicago Press, 1997).

Ott, Ursula F. and Pervez N. Ghauri. 'Brexit negotiations: From negotiation space to agreement zones', *Journal of International Business Studies*, vol. 50, no. 1 (2019).

Park, Soonchan. 'The trade depressing and trade diversion effects of antidumping actions: the case of China', *China Economic Review*, vol. 20, no. 3 (2009).

Ramstetter, Eric D. 'Export performance and foreign affiliate activity in Japan's large machinery firms', *Transnational Corporations*, vol. 6, no. 3 (December 1997).

Rugman, Alan M. *Multinational Enterprises and Trade Policy* (Cheltenham: Edward Elgar, 1996).

Rugman, Alan M. and Anderson, Andrew. *Administered Protection in America* (London: Croom Helm and New York: Methuen, 1987).

Rugman, Alan M. and Boyd, Gavin (eds.). *The World Trade Organization in the New Global Economy* (Cheltenham: Edward Elgar, 2001).

Rugman, Alan M. and Gestrin, Michael. 'US trade laws as barriers to globalization', in Tamir Agmon and Richard Drobnick (eds.), *Small Firms in Global Competition* (New York: Oxford University Press, 1994).

Rugman, Alan M. and Verbeke, Alain. *Global Corporate Strategy and Trade Policy* (London and New York: Routledge, 1990).

Rugman, Alan M. and Verbeke, Alain. 'Strategic trade policy is not good strategy', *Hitotsubashi Journal of Commerce and Management*, vol. 25, no. 1 (December 1990).

Rugman, Alan M. and Verbeke, Alain. 'Location, competitiveness, and the multinational enterprise', in Alan M. Rugman (ed.), *The Oxford Handbook of International Business* (Oxford: Oxford University Press, 2009).

Rugman, Alan M. and Verbeke, Alain. (eds) *Global Corporate Strategy and Trade Policy* (Routledge, 2017).

Vandenbussche, Hylke and Zanardi, Maurizio. 'The chilling trade effects of antidumping proliferation', *European Economic Review*, vol. 54, no. 6 (2010).

APPENDIX: BALANCE OF PAYMENTS

How well do we keep track of the millions of transactions that take place annually among exporters and importers, international banks and multinational companies? The bankers who tabulate the foreign exchange dealings of their own banks are only a part of the picture. How well can we account for the part of direct investment that occurs through overseas borrowing, yet affects the home country's international economic position? Even more simply, how well can we measure 'international' transactions that are simply transfers of funds from the account of an importer to the account of a foreign exporter in the same bank?

The realistic answer to these questions is: not very well. National governments create elaborate accounts for the transactions between their residents and foreign residents, but it is often very difficult to obtain full and accurate information. Putting that problem aside for the moment, let us consider the methods that governments use to record each country's international transactions.

The most widely used measure of international economic transactions for any country is the **balance of payments (BOP)**. This record attempts to measure the full value of the transactions between residents of one country and residents of the rest of the world for some time period, typically one year. The balance of payments is a flow concept, in that it records flows of goods, services and claims between countries over a period of time, rather than a stock of accumulated funds or products. It is a value concept, in that all the items recorded receive a monetary value, denominated in the given country's currency at the time of those transactions. *The balance of payments thus is a record of the value of all the economic transactions between*

residents of one country and residents of all other countries during a given time period.

Why do we worry about measuring these transactions? We do so because if a country records a substantial imbalance between inflows and outflows of goods and services for an extended period of time, some means of financing or adjusting away the imbalance must be found. For example, if the Eurozone countries record a persistent trade deficit with China for several years, there will be pressure either to devalue the euro relative to the Chinese currency, the renminbi, or for Chinese investors to place large and continuing investments into euro-denominated securities. This pressure presents both a political outcome (pressure on the Chinese government to revalue the renminbi) and an economic outcome (pressure on the euro to devalue and on European producers to lower their costs, perhaps by producing in China).

So, the importance of the balance of payments is not only macroeconomic, in the domain of government accountants, but also managerial, since an imbalance provides guidance to managers about expected government policies as well as about opportunities to take advantage of currency opportunities. Since the relatively open foreign exchange markets of many countries today leave the exchange rate substantially to supply and demand, the balance of payments is an indicator of exactly that supply and demand for a country's currency that will lead to changes in the exchange rate.

The supply and demand for a currency come from both trade flows (exports and imports) and capital flows (investments and borrowing). So, the balance of payments implications for exchange rates must include both sides of the story, the 'real' flows and the financial flows.

Balance of payments accounting

There is no such thing as the balance of payments, since the accounts are organised in a double-entry bookkeeping system, and for every debit entry there is a credit entry of equal value. There are half a dozen BOP measures, which group some international transactions together and leave others in a second, 'everything else' category. In each case the intent is to place the fundamental economic causes of transactions in the first group and leave the payments for them in the second group. In the actual accounts, the former transactions are listed 'above the line', and the payments are left 'below the line'.

Current account

The **current account** consists of merchandise trade, services and unilateral transfers (see Table 6A, parts A and B).

Merchandise trade is typically the first part of the current account. It receives more attention than any of the other accounts because this is where the imports and exports of goods are reported, and these are often the largest single component of all international transactions. In this account, sales of goods to foreigners (exports) are reported as credits because they are a source of funds or a claim against the purchasing country. Conversely, purchases of goods from overseas (imports) are recorded as debits because they use funds. This payment can be made by either reducing current claims on foreigners or increasing foreign liabilities.

Merchandise trade transactions can affect a country's BOP in a number of ways. Assume that Nissan Motor of Japan has sold General Motors in the United States $600,000 worth of engines and these engines will be paid for from GM's account in a Detroit bank. In this case the imports are a debit to the current account (A-1) and a credit to the 'other short-term, private' capital account (C-6b). Here is how the entry would be recorded:

Table 6A Balance of payments: IMF presentation

	Debits	Credits
I Current account		
A Goods, services, and income:		
1 Merchandise	Imports from foreign sources (acquisition of goods)	Exports to foreign destinations (provision of goods)
Trade balance		
2 Shipment and other transportation	Payments to foreigners for freight and insurance on international shipments; for ship repair, stores and supplies; and international passenger fares	Receipts by residents from foreigners for services provided
3 Travel	Expenditures by residents (including internal transportation) when travelling in a foreign country	Receipts by residents for goods and services (including internal transportation) sold to foreign travellers in reporting country
4 Investment income	Profits of foreign direct investments in reporting country, including reinvested earnings; income paid to foreigners as interest, dividends, etc.	Profits of direct investments by residents in foreign countries, including reinvested earnings; income received by residents from abroad as interest, dividends, etc.
5 Other official	Foreign purchases by government not included elsewhere; personal expenditures of government civilian and military personnel stationed in foreign countries	Expenditures of foreign governments for goods and services, not included elsewhere; personal expenditures of foreign civilian and military personnel stationed in reporting country
6 Other private	Payments to foreigners for management fees, royalties, film rentals, construction, etc.	Receipts from foreigners for management fees, royalties, film rentals, construction, etc.
Goods, services, and income balance		
B Unilateral transfers:		
1 Private	Payments in cash and kind by residents to foreigners without a quid pro quo such as charitable gifts and gifts by migrants to their families	Receipts in cash and kind by residents from foreigners, individuals, or governments without a quid pro quo
2 Official	Transfers by government of reporting country for pensions, reparations, and grants for economic and military aid	Transfers received by government from foreigners in the form of goods, services, or cash as gifts or grants. Also tax receipts from non-residents
Current account balance		
II Capital account		
C Capital, excluding reserves:		
1 Direct investment	(a) Increased investment in foreign enterprises controlled by residents, including reinvestment of earnings (b) Decreases in investment by residents in domestic enterprises controlled by foreigners	(a) Decreased investment in foreign enterprises controlled by residents (b) Increases in investment in domestic enterprises by foreigners
2 Portfolio investment	(a) Increases in investment by residents in foreign securities (b) Decreases in investment by foreigners in domestic securities such as bonds and corporate equities	(a) Decreases in investments by residents in foreign securities (b) Increases in investment by foreigners in domestic securities
3 Other long-term, official	(a) Loans to foreigners (b) Redemption or purchase from foreigners of government securities	(a) Foreign loan reductions (b) Sales to foreigners of government securities
4 Other long-term, private	(a) Long-term loans to foreigners by resident banks and private parties (b) Loan repayments by residents to foreign banks or private parties	(a) Long-term loans by foreigners to resident banks or private parties (b) Loan repayments by foreigners to residents
5 Other short-term, official	(a) Short-term loans to foreigners by central government (b) Purchase from foreigners of government securities, decrease in liabilities constituting reserves of foreign authorities	(a) Short-term loans to resident central government by foreigners (b) Foreign sales of short-term resident government securities, increases in liabilities constituting reserves of foreign authorities
6 Other short-term, private	(a) Increases in short-term foreign assets held by residents (b) Decreases in domestic assets held by foreigners, such as bank deposits, currencies, debts to banks, and commercial claims	(a) Decreases in short-term foreign assets held by residents. Increase in foreign liabilities of residents (b) Increase in domestic short-term assets held by foreigners or decrease in short-term domestic liabilities to foreigners
III Reserves		
D Reserves:		
1 Monetary gold 2 Special drawing rights (SDRs) 3 IMF reserve position 4 Foreign exchange assets	Increases in holdings of gold, SDRs, foreign convertible currencies by monetary authorities; decreases in liabilities to IMF or increase in IMF assets position	Decreases in holdings of gold, SDRs, foreign convertible currencies by monetary authorities; increases in liabilities to IMF or decrease in IMF assets position
E Net errors and omissions:	Net understatement of recorded debts or overstatement of recorded credits	Net understatement of recorded debts or overstatement of recorded credits
Balances:		
Balances on merchandise trade	A-1 credits minus A-1 debits	
Balance on goods, services, and income	A-1 through A-6 credits minus A-1 through A-6 debits	
Balance on current account	A and B credits minus A and B debits	

		Debit	Credit
A-1	Merchandise imports	$600,000	
C-6b	Increase in domestic short-term assets held by foreigners		$600,000

The result of this purchase is that the United States has transferred currency to foreigners and thus reduced its ability to meet other claims.

Services

The services category includes many payments such as freight and insurance on international shipments (A-2); tourist travel (A-3); profits and income from overseas investment (A-4); personal expenditures by government, civilians and military personnel overseas (A-5); and payments for management fees, royalties, film rental and construction services (A-6). Purchases of these services are recorded as debits, while sales of these services are similar to exports and are recorded as credits. For example, extending the earlier example of Nissan and GM, assume that the US auto maker must pay $125,000 to Nissan to ship the engines to the United States. The transaction would be recorded this way:

		Debit	Credit
A-2	Shipment	$125,000	
C-6b	Other short-term private capital		$125,000

GM purchased a Japanese shipping service (a debit to the current account) and paid for this by increasing the domestic short-term assets held by foreigners (a credit to the capital account).

Unilateral transfers

Unilateral transfers are transactions that do not involve repayment or the performance of any service. Examples include the American Red Cross sending $10 million in food to refugees in Somalia; the United States paying

military pensions to residents of the Philippines who served in the US Army during World War II; and British workers in Kuwait shipping money home to their families in London. Here is how the American Red Cross transaction would appear in the US BOP:

		Debit	Credit
B-1	Unilateral transfers, private	$10 million	
A-1	Merchandise exports		$10 million

Capital account

Capital account items are transactions that involve claims in ownership. Direct investment (C-1) involves managerial participation in a foreign enterprise along with some account that involves degree of control. The United States classifies direct investments as those investments that give the investor more than 10 per cent ownership. Portfolio investment (C-2) is investment designed to obtain income or capital gains. For example, if Exxon shipped $20 million of equipment to an overseas subsidiary the entry would be:

		Debit	Credit
C-1	Direct investment	$20 million	
A-1	Exports		$20 million

‘Other long-term’ capital accounts are differentiated based on whether they are government (C-3) or private (C-4) transactions. These transactions have a maturity of over one year and involve either loans or securities. For example, Citibank may have loaned the government of Poland $50 million. ‘Other short-term’ capital accounts are also differentiated based on whether they are governmental (C-5) or private (C-6). Typical short-term government transactions are short-term loans in the securities of other governments. Private transactions often include trade bill acceptances or other short-term

claims arising from the financing of trade and movements of money by investors to take advantage of interest differentials among countries.

Official reserves

Official reserves are used for bringing BOP accounts into balance. There are four major types of reserves available to monetary authorities in meeting BOP deficits (D1 through D4 in Table 6A). These reserves are analogous to the cash or near-cash assets of a private firm. Given that billions of dollars in transactions are reported in BOP statements, it should come as no surprise that the amount of recorded debits is never equal to the amount of credits. This is why there is an entry in the reserve account for net errors and omissions. If a country's reporting system is weak or there are a large number of clandestine transactions, this discrepancy can be quite large.

US BOP

The official presentation of the US BOP is somewhat different from the IMF format presented in Table 6A. Because the United States plays such a dominant role in the world economy, it is important to examine the US system. Table 6B presents US international transactions for 2017.

A number of select entries in Table 6B help to highlight the US BOP. Lines 2 and 32 show that in 2017 exports of goods and services were \$552.277 billion less than imports. The trade deficit has declined since 2008, when it was \$695.936 billion, and 2006, when it stood at \$763.267 billion. The United States continues to have trade deficit problems, but on a BOP basis this is improving.

To assess the trade situation accurately, however, we need to examine the data in more depth. This information is provided in Table 6C. The table shows that although US exports are strong in areas such as capital goods and industrial supplies and materials, the country also imports a large amount of

these products. In addition, the United States is a net exporter of foods, feeds and beverages, automotive vehicles and parts, consumer goods, and petroleum and products.

In the early 1980s US trade deficits were offset by large amounts of income generated by direct investments abroad. Later in the decade massive international borrowing offset these deficits. More recently the situation has improved somewhat, and dollar devaluation has helped to generate stronger demand for US exports, thus partially reducing the growth rate of its annual trade deficit. However, more concerted action will be needed if the United States is to continue on this course. One way is to continue to increase US competitiveness in the international market. Another way is to get other countries to reduce their trade barriers and to make international markets more open.

When a country suffers a persistent balance of trade deficit, the nation will also suffer from a depreciating currency and will find it difficult to borrow in the international capital market. In this case there are only two choices available. One is to borrow from the IMF and be willing to accept the restrictions that the IMF puts on the country, which are designed to introduce austerity and force the country back on to the right economic track. The other approach is for the country to change its fiscal policy (tariffs and taxes), resort to exchange and trade controls, or devalue its currency. To prevent having to undertake austerity steps, the United States will have to continue working very hard to control its trade deficit.

Table 6B US international transactions, 2017 (millions of US$)

		2017
1	Exports of goods and services and income receipts (credits)	3,433,239
2	Exports of goods and services	2,351,072
3	Goods	1,553,383
4	General merchandise	1,531,639

5	Foods, feeds and beverages	132,744
6	Industrial supplies and materials	456,188
7	Capital goods except automotive	533,574
8	Automotive vehicles, parts and engines	157,641
9	Consumer goods except food and automotive	197,134
10	Other general merchandise	54,358
11	Net exports of goods under merchanting	200
12	Nonmonetary gold	21,544
13	Services	797,690
14	Maintenance and repair services n.i.e.	26,430
15	Transport	88,598
16	Travel (for all purposes including education)	210,747
17	Insurance services	18,047
18	Financial services	109,642
19	Charges for the use of intellectual property n.i.e.	128,364
20	Telecommunications, computer, and information services	42,219
21	Other business services	154,313
22	Government goods and services n.i.e.	19,329
23	Primary income receipts	928,118
24	Investment income	921,816
25	Direct investment income	504,404
26	Portfolio investment income	354,406
27	Other investment income	62,620
28	Reserve asset income	385
29	Compensation of employees	6,302
30	Secondary income (current transfer) receipts	154,049
31	Imports of goods and services and income payments (debits)	3,882,380
32	Imports of goods and services	2,903,349
33	Goods	2,360,878
34	General merchandise	2,348,675
35	Foods, feeds, and beverages	138,810
36	Industrial supplies and materials	511,561
37	Capital goods except automotive	643,620
38	Automotive vehicles, parts, and engines	359,849
39	Consumer goods except food and automotive	603,922
40	Other general merchandise	90,913
41	Nonmonetary gold	12,203

42	Services	542,471
43	Maintenance and repair services n.i.e.	8,337
44	Transport	101,744
45	Travel (for all purposes including education)	135,024
46	Insurance services	50,665
47	Financial services	28,931
48	Charges for the use of intellectual property n.i.e.	51,284
49	Telecommunications, computer, and information services	40,054
50	Other business services	104,385
51	Government goods and services n.i.e.	22,047
52	Primary income payments	706,386
53	Investment income	686,699
54	Direct investment income	205,976
55	Portfolio investment income	432,510
56	Other investment income	48,213
57	Compensation of employees	19,687
58	Secondary income (current transfer) payments	272,645
	Capital account	
59	Capital transfer receipts and other credits	24,788
60	Capital transfer payments and other debits	42
	Financial account	
61	Net US acquisition of financial assets excluding financial derivatives (net increase in assets / financial outflow (+))	1,182,749
62	Direct investment assets	379,222
63	Equity	352,504
64	Debt instruments	26,718
65	Portfolio investment assets	586,695
66	Equity and investment fund shares	166,827
67	Debt securities	419,868
68	Short term	193,855
69	Long term	226,013
70	Other investment assets	218,522
71	Currency and deposits	171,952
72	Loans	40,862
74	Trade credit and advances	5,708
75	Reserve assets	-1,690
76	Monetary gold	0
77	Special drawing rights	78

78	Reserve position in the International Monetary Fund	-1,812
79	Other reserve assets	44
80	Currency and deposits	0
81	Securities	44
82	Financial derivatives	0
83	Other claims	0
84	Net US incurrence of liabilities excluding financial derivatives (net increase in liabilities / financial inflow (+))	1,537,683
85	Direct investment liabilities	354,829
86	Equity	308,406
87	Debt instruments	46,423
88	Portfolio investment liabilities	799,182
89	Equity and investment fund shares	155,680
90	Debt securities	643,503
91	Short term	15,851
92	Long term	627,652
93	Other investment liabilities	383,671
94	Currency and deposits	217,427
95	Loans	150,834
97	Trade credit and advances	15,410
98	Special drawing rights allocations	0
99	Financial derivatives other than reserves, net transactions	23,074
	Statistical discrepancy	
100	Statistical discrepancy	92,536
	Balances	
101	Balance on current account (line 1 less line 31)	-449,142
102	Balance on goods and services (line 2 less line 32)	-552,277
103	Balance on goods (line 3 less line 33)	-807,495
104	Balance on services (line 13 less line 42)	255,219
105	Balance on primary income (line 23 less line 52)	221,731
106	Balance on secondary income (line 30 less line 58)	-118,597
107	Balance on capital account (line 59 less line 60)	24,746
108	Net lending (+) or net borrowing (->) from current- and capital-account transactions (line 101 plus line 107)	-424,395
109	Net lending (+) or net borrowing (-) from financial-account transactions (line 61 less line 84 plus line 99)	-331,860

Source: https://fred.stlouisfed.org/release/tables?rid=49&eid=4.

Table 6C **US merchandise trade, 2017 (millions of US$)**

US Exports	
Agricultural products	153,116
Forest products	39,698
Chemicals and related products	227,270
Energy-related products	143,236
Textiles and apparel	22,082
Footwear	1,430
Minerals and metals	136,452
Machinery	135,945
Transportation equipment	325,434
Electronic products	268,278
Miscellaneous manufactures	49,138
Special provisions	44,655
Total	1,546,733
US Imports	
Agricultural products	147,406
Forest products	44,856
Chemicals and related products	268,112
Energy-related products	198,096
Textiles and apparel	121,423
Footwear	25,654
Minerals and metals	200,714
Machinery	196,414
Transportation equipment	434,894
Electronic products	484,271
Miscellaneous manufactures	130,453
Special provisions	90,610
Total	2,342,905
Total	-796,172

Source: https://www.usitc.gov/research_and_analysis/trade_shifts_2017/us.htm.

Key terms

- **balance of payments (BOP)**

- **current account**
- **capital account**
- **official reserves**

Chapter 7

INTERNATIONAL FINANCIAL MARKETS AND INSTITUTIONS

Contents

Objectives of the chapter

This chapter examines the operation of financial markets that allow firms access and use funding outside their home countries and to deal in foreign currencies, allowing them to conduct international business. It also considers the risks involved in operating in these markets and the tools available to deal with those risks. The main risk has to do with dealing in foreign currencies, so **exchange risk** and the functioning of the **foreign exchange** market are key elements of the discussion.

The specific objectives of this chapter are to:

1. *Review* the basic characteristics of all the financial markets that may be available to a firm in international business.
2. *Examine* the foreign exchange market, its operation and the main participants.
3. *Explain* the fundamental economic factors that determine exchange rates in the absence of government intervention in foreign exchange markets.
4. *Show* how firms can operate successfully in more than one currency without facing unacceptable levels of exchange risk.
5. *Give insights* into domestic money and capital markets that exist around the world.
6. *Describe* the functioning of the Euromarkets and the international monetary system and how they relate to both private sector firms and governments.
7. *Look at* a country's balance of payments and show what lessons can be drawn from it.
8. *Show* how firms can take advantage of the opportunities available in all of these markets.

ACTIVE LEARNING CASE

Barclays Bank international financial dealings

Barclays Bank is one of the largest banks in the world and the second largest in the UK after HSBC in terms of assets (in 2017). It has a worldwide spread of branches, representative offices and other affiliates, and is actively involved in businesses such as corporate finance for major firms around the world, retail banking in the UK and Europe, and foreign exchange dealing in London, New York, Tokyo and other financial capitals of the world. At the height of the financial crisis it avoided taking bailout funds from the UK government and survived 2008–09 better than most.

At the end of 2017 Barclays' business portfolio was divided among the currencies shown in Table 7.1. Growth in income and costs was constrained by foreign exchange translation movements. These are not necessarily major concerns for a multinational bank, since Barclays has lengthy experience in using these currencies, and the bank regularly deals with foreign exchange risk. However, other banks had encountered huge crises due to foreign exchange losses. For example, National Australia Bank lost US$360 million in 2003/4 due to currency trading, and Allied Irish Banks lost more than US$770 million in 2002 from similar trading. Back in 1974 the entire world financial system was shaken by a pair of foreign exchange losses that caused two banks to fail (Franklin National Bank in the United States and Bankhaus Herstatt in Germany) and the entire **eurocurrency** system to briefly come to a halt. In 2008 the British government nationalised Northern Rock to prevent its failure, while banks in the United States also faced failure due to losses on the subprime mortgage market leading to the world financial crisis.

In 2018, Barclays employed approximately 80,000 people and the firm's business interests spanned more than 30 countries worldwide. At its heart, however, Barclays was a home-region bank, with 62 per cent of its revenues in Europe (75 per cent if we include off-balance sheet risks). A geographical analysis of revenues from external customers for continuing operations for the year ended 31 December 2017 (Table 7.2) shows that 44 per cent of Barclays' revenues were in the UK, the bank's country of origin (42 per cent if we include off-balance sheet numbers). Another 24 per cent of the bank's business was in other European Union countries, about 27 per cent in the United

States and the remaining 5 per cent elsewhere. This left the bank exposed to a number of risks, as Table 7.1 shows, including a large exposure in US dollars.

From another perspective, Barclays was financially exposed to additional risks from its lending activities in various countries. Table 7.1 shows this distribution of activity.

Table 7.1 The Barclays Group's structural currency exposures as at 31 December 2017

Functional currency of operations	Foreign currency net investments £m	Borrowings which hedge the net investments £m	Derivatives which hedge the net investments £m	Structural currency exposures pre-economic hedges £m	Economic hedges £m	Remaining structural economic exposures £m
As at 31 December 2017						
US dollar	27,848	(12,404)	(540)	14,904	(6,153)	8,751
Euro	2,489	(3)	-	2,486	(2,127)	359
Rand	8	–	-	8	–	8
Japanese yen	467	(152)	(301)	14	–	14
Other	2,475	–	(1,299)	1,176	–	1,176
Total	33,287	(12,559)	(2,140)	18,588	(8,280)	10,308
As at December 31, 2016						
US dollar	29,460	(12,769)	-	16,691	(7,898)	8,793
Euro	2,121	(363)	-	1,758	(2,053)	(295)
Rand	3,679	–	(2,571)	1,108	–	1,108
Japanese yen	438	(209)	(224)	5	–	5
Other	2,793	–	(1,318)	1,475	–	1,475
Total	38,491	(13,341)	(4,113)	21,037	(9,951)	11,086

Table 7.2 Analysis of loans and advances to customers as at 31 December 2017

Credit risk concentrations by geographical sector (£m)	United Kingdom £m	Europe £m	Americas £m	Africa and Middle East £m	Asia £m	Total £m
As at 31 December 2014						
The Group						
On-balance sheet:						
Cash and balances at central banks	53,068	57,179	56,034	63	4,738	171,082
Items in the course of collection from other banks	987	1,166	–	-	–	2,153
Trading portfolio assets	10,603	13,620	25,680	473	3,964	54,340
Financial assets designated at fair value	33,922	23,725	46,288	1,611	6,065	111,611
Derivative financial instruments	81,656	81,566	57,858	2,792	13,797	237,669
Loans and advances to banks	10,251	11,847	8,044	1,714	3,807	35,663
Loans and advances to customers	253,702	39,687	63,246	2,541	6,376	365,552
Reverse repurchase agreements and other similar secured lending	203 375	375	10,521	32	1,415	12,546
Financial investments – debt securities	17,471	23,598	14,110	114	1,836	57,129
Other assets	592	13	148	33	83	869
Total on-balance sheet	462,455	252,776	281,929	9,373	42,081	1,048,614
Off-balance sheet:						
Contingent liabilities	7,603	3,039	6,708	529	1,133	19,012
Documentary credits and other short-term trade-related transactions	800	5	–	7	-	812
Standby facilities, credit lines, and other commitments	105,112	36,079	168,003	1,601	3,966	314,761
Total off-balance sheet	113,515	39,123	174,711	2,137	5,099	334,585
Total	575,970	201,899	456,640	11,510	47,180	1,383,199

Website: www.barclays.com.

Source: Barclays, *Annual Report*, 2014–18.

A key concern for Barclays is how to manage these overseas and foreign currency activities, especially with respect to the risk of currency losses. As an international bank, Barclays wants to operate in major financial centres, but as a prudently managed firm, it doesn't want to take undue risk in foreign currencies or put significant amounts of assets in high-risk environments.

1. **What exchange risk does Barclays have as at 31 December 2017?**
2. **What should Barclays' expectation be about the value of the pound relative to the euro or the dollar?**
3. **How should Barclays deal with the risk involved in its foreign currency positions?**
4. **How can Barclays use the eurocurrency market in its international business, and will this help in dealing with the exchange rate problem?**

INTRODUCTION

International financial markets are relevant to companies, whether or not they become directly involved in international business through exports, direct investment, and the like. Purchases of imported products or services may require payment in foreign exchange, thus involving exchange risk. A company may choose to invest in a foreign business or security, and face both different interest rates and different risks from those at home. Often companies find that borrowing funds abroad is less expensive than borrowing domestically, in the United States or in any other home country. The relatively unrestricted 'euromarkets' generally offer better terms to borrowers (*and* lenders) than do domestic financial markets in any country. Likewise, in today's global financial markets, investors are discovering more and more opportunities to diversify their portfolios into holdings of foreign securities. This chapter explores the various foreign and international financial markets, including the foreign exchange market, and examines ways to utilise them for domestic and international business.

FOREIGN EXCHANGE MARKETS

Currencies, like any other products, services or claims, can be traded for one another. The foreign exchange market is simply a mechanism through which transactions can be made between one country's currency and another's. Or, more broadly, a foreign exchange market is a market for the exchange of financial instruments denominated in different currencies.

Foreign exchange is not simply currency printed by a foreign country's central bank; rather, it includes such items as cash, cheques (or drafts), wire transfers, online transfers and even contracts to sell or buy currency in the future. Foreign exchange is really any financial instrument that carries out payment from one currency to another. The most common form of foreign exchange in transactions between companies is the draft (denominated in a foreign currency). The most common form of foreign exchange in transactions between banks is an online transfer, generally for transactions of $1 million or more. Far down the list of instruments, in terms of the value exchanged, is actual currency, which is often exchanged by tourists and other travellers.

Since no currency is necessarily fixed in value relative to others, there must be some means of determining an acceptable price, or **exchange rate**. How many British pounds (£) should one dollar buy? How many Brazilian reals should be paid to buy a dollar? Most of the industrialised countries have allowed their currency values to fluctuate more or less freely (depending on the time and the country), so that the simple economics of supply and demand largely determines exchange rates. In graphic form, Figure 7.1 shows that the intersection of the supply curve and the demand curve for European euros (€) sets the price, or exchange rate, of euros in terms of dollars. Some of the

participants in the foreign exchange market are listed below the graph; their specific activities are discussed in the following section.

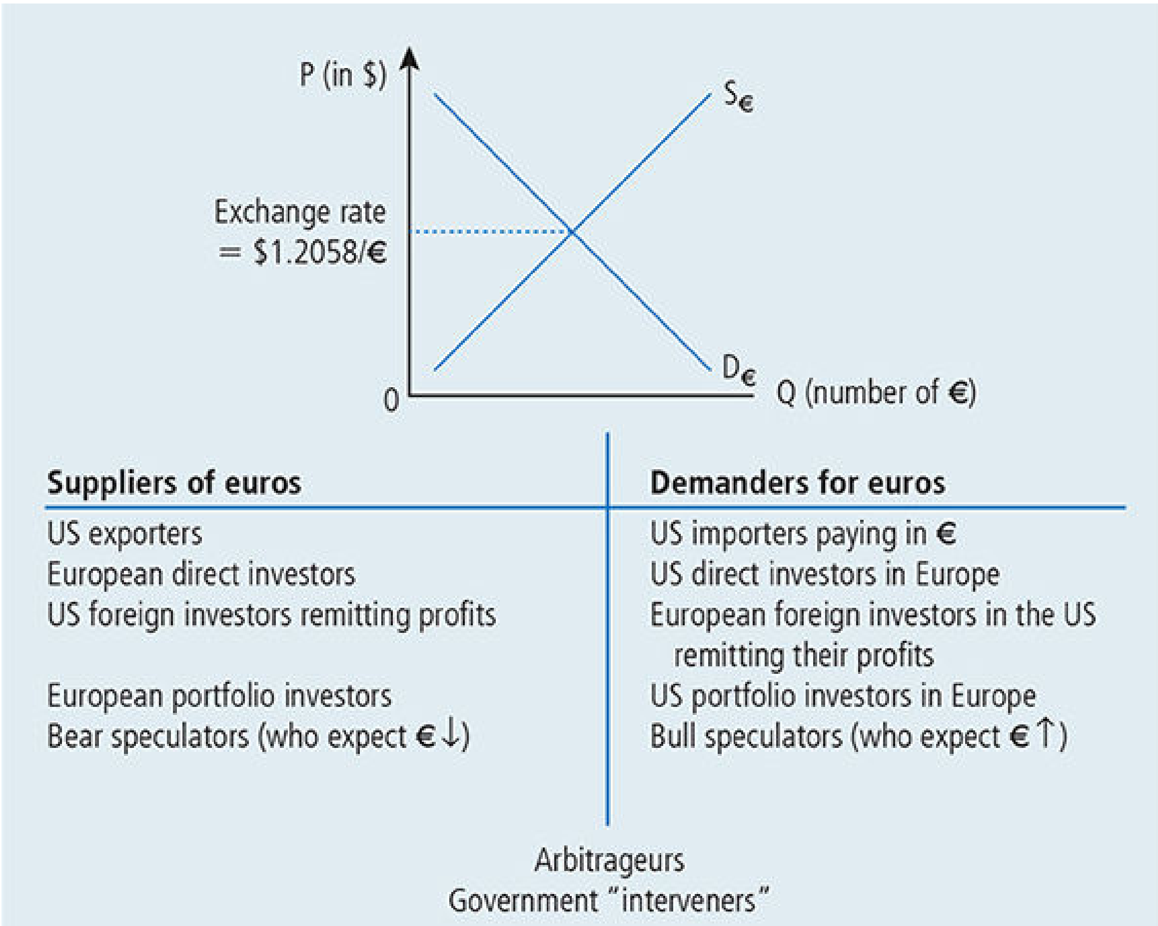

Figure 7.1 Foreign exchange market for euros in New York

The exchange rate of $1.2378 per euro is offered by one specific bank. This was the closing exchange rate quoted by Bankers Trust Company of New York for purchases of at least $1 million worth of euros on a particular date. Another bank in New York may have quoted a slightly higher or slightly lower rate at the same time, and banks in San Francisco, London or Tokyo probably quoted rates that differed even more. The rates quoted depend on each bank's interest in being involved in foreign exchange transactions and on the varying strategic positions and risks taken by the banks. Thus, the foreign exchange market among banks may be viewed as one large market or as many

small markets with extensive (potential and actual) interrelations. Generally, the interbank market within any country is viewed as one market, and intercountry dealings are somewhat segmented by different rules and risks (though in the United States, the San Francisco market often offers quotations from various banks that differ noticeably from rate quotations in New York, due partly to the difference in time zones).

The differences in rate quotations may appear very small to an outsider. For example, euros may be quoted at $1.23236 at Citibank in New York and at $1.23386 at Bank of America in San Francisco. This difference seems small, but for every 1 million euros sold, the buyer of dollars in San Francisco receives an extra $1,500. Since the transactions are generally rapid, for values of $5 million to $10 million such differences may add up to a substantial gain (or cost) to the participant in the foreign exchange market.[1]

The various foreign exchange transactions just mentioned involve large commercial banks and large amounts of money. Most of the companies that do international business also utilise foreign exchange markets, but far less frequently than banks and for transactions that involve less money. Consequently, these companies' access to foreign currencies differs from that of the banks. (Specifically, banks make the market and companies pay for the use of this service.) The next section describes the various participants in the US foreign exchange market.

Foreign exchange markets in the United States

Figure 7.2 presents an overview of the foreign exchange markets operating today in the United States. This section discusses each of these markets in some detail.

The interbank market

Although the foreign exchange dealings of most managers involve a company buying from, or selling to, a bank, managers must understand the foreign exchange market among banks. This is because, as noted above, the vast majority of large-scale foreign exchange transactions are interbank, and these transactions tend to determine exchange rates, with which occasional market participants such as companies must deal.

Local and regional commercial banks may offer clients a foreign exchange service, which such banks provide on request by dealing through a larger bank, typically in a large city (such as New York, Los Angeles or Chicago). If a local bank receives a request to buy Swiss francs (SF) for an importer in New Jersey, it will call its correspondent bank in New York (say, JP Morgan Chase Bank) and arrange to buy the SF for, say, $0.6753/SF. Then the local bank will add on its service charge so that the importer pays $0.6853/SF. Thus, the local bank earns $0.01 per SF, or about 1.5 per cent on the transaction.

JP Morgan Chase Bank, in turn, will either take the requested Swiss francs from its own holdings of that currency or enter the interbank market to buy them. Assuming that Chase does *not* have the SF on hand, one of its **foreign exchange traders** will call several other major banks (or brokerage houses, which are discussed below) and contract to buy Swiss francs from the lowest bidder.

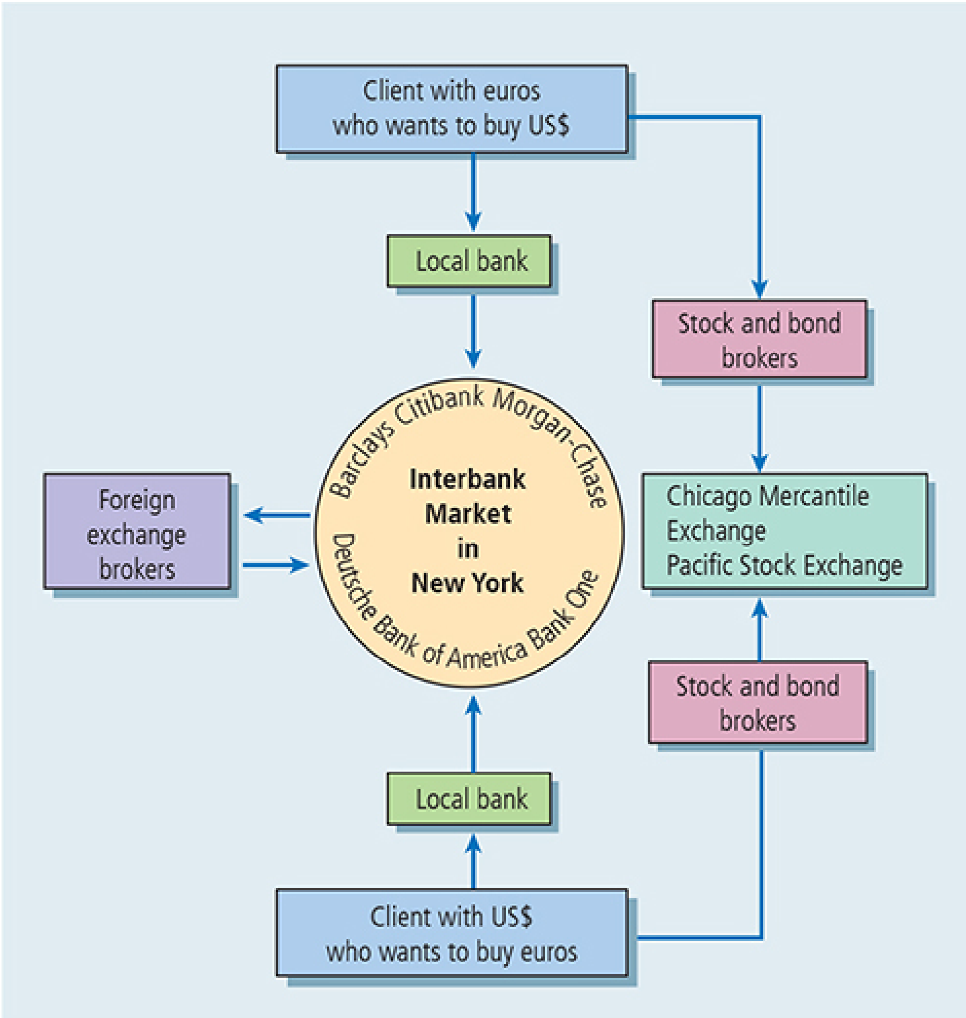

Figure 7.2 US foreign exchange markets

Source: Adapted from K. Alec Chrystal, *St. Louis Fed Review* (March 1984), figure 1, p. 8.

The interbank market generally operates with large transactions only of about $1 million to $10 million exchanged for the equivalent foreign currency. On a typical day the main US clearing house, the Clearing House Interbank Payments System (or CHIPS) settles more than $1 trillion USD in currency trades, with the average transaction being over $3,000,000.

The brokers' market

Another facet of large-scale foreign exchange dealing in the United States is the brokers' market. About six **foreign exchange brokers** make markets for

foreign currencies in New York (as well as in London and elsewhere), creating trading in many currencies similar to that in the interbank market. In this case, the key differences are that the brokers seek to match buyers and sellers on any given transaction, without taking a position[2] themselves; they deal simultaneously with many banks (and other companies); and they offer both buy and sell positions to clients (where a bank may wish to operate on only one side of the market at any particular time). Also, the brokers deal 'blind', offering rate quotations without naming the potential seller/buyer until a deal has been negotiated. Brokers play a large role in the total market, arranging about half of total interbank foreign exchange transactions.

Before moving on to other foreign exchange markets, let us consider an example in which the spot market is used by a tourist planning a trip to Japan. This person wants to visit Tokyo to see a friend during the Christmas vacation and to do some sightseeing. She is taking $1,000 with her and has already purchased the round-trip airline ticket. Since dollars cannot be used for most purchases in Japan, she needs to buy Japanese yen. How should she do it?

Looking at the currency trading listing in Table 7.3, she saw that Bankers Trust was offering to sell large quantities of yen at the rate of 120.98 yen per dollar. At the 'retail' level – that is, for small transactions such as this one – she could expect to receive fewer yen per dollar. Instead of carrying the cash with her, she wanted to get traveller's cheques. Upon calling the office of American Express in San Francisco, she found that yen-denominated traveller's cheques are available but would cost her the exchange rate, plus a $5 service charge.

Table 7.3 Exchange rates in the interbank market, 29 October 2015

Foreign currency Exchange rates	UK sterling (£)	Europe euro (€)	Japan yen (¥)
Spot rate – closing (foreign currency units per US dollar)	1.5282	1.0958	0.00826
Forward rate – closing			
1 month outright	1.5150	1.0674	0.00816
3 months outright	1.4947	1.0950	0.00845
12 months outright	1.4518	0.9504	0.00742

FT *Source*: Financial Times, 29 October 2015.

The tourist was willing to pay the extra cost to obtain the protection of traveller's checks, but one final problem arose. A friend who works in foreign exchange dealing at Wells Fargo Bank told her that the yen would probably decline in value relative to the dollar in the next few days. Since she would not leave for Tokyo for another week, she wondered whether it was worth waiting for the expected devaluation. The answer to this question is that no one knows! She could hope for a devaluation and delay purchase of the yen for a week, or ignore the potential gain or loss and buy the yen today. In such a short time period, it is probably better to ignore the few days' variability in the exchange rate – since it could be favourable or unfavourable – and just buy the yen at the most convenient time before departing for Tokyo.

Although this example does not offer a guaranteed way to make money from foreign exchange dealings, it does illustrate the kinds of problems that beset individuals and companies as they work with foreign currencies. Fortunately, there are some methods to help avoid the uncertainty involved in foreign exchange; they are discussed in the section below on 'Protecting against exchange risk'.

So far, our discussion has focused only on the *spot market*: that is, the market for immediate exchange of one currency for another. An additional, very large part of the US foreign exchange market is the set of instruments that allow contracting today for delivery of currency in the future. The main

instruments of this type are forward contracts, foreign exchange futures contracts and foreign currency options.

The forward foreign exchange market

The forward foreign exchange market at commercial banks in the United States offers banks, companies and individuals the opportunity to contract *today* for a specific foreign exchange transaction in the *future*, at a fixed price (that is, exchange rate). Forward contracts are negotiated between the offering bank and the client as to size, maturity and price. Referring to Table 7.3, we see that Bankers Trust was offering to sell British pounds for $1.4518/£ in 360 days on 29 October 2015 (for quantities of at least $1 million).

The rationale for forward contracts in currencies is analogous to that for futures contracts in commodities: the firm can lock in a price today to eliminate uncertainty about the value of a future receipt or a payment of foreign currency. A firm may undertake such a transaction because it has made a previous contract: for example, to pay €1 million to a supplier in three months for some needed inputs to its operations. If the firm wants to eliminate the risk that its payment in three months will change in dollar terms (that is, the €1 million may cost more dollars then), it can contract with a bank to buy €1 million three months forward, at a price established today. (From Table 7.3, we see that the price was $1.0958/€ for a contract with Bankers Trust on 29 October 2015.) Thus, firms can use forward contracts to eliminate the risk of variability in future dollar costs or revenues due to exchange rate changes. This concept, called *hedging*, and other motives for using the forward market are discussed later.

Notice that in the above example, the forward contract used for hedging is not the same thing as an insurance contract. The forward contract does fix a minimum 'loss' for the firm by setting the guaranteed price of exchange in the future. Even if the dollar devalues to $0.95 per € in three months, the forward

contract holder is still able to buy €1 million at a better rate than this to limit his/her losses. However, if the euro devalues over the next three months to, say, \$1/€, the forward contract holder will have an opportunity cost of the difference between the forward rate and the (eventual) future spot rate. Thus, the forward contract insures against potential losses *and* against potential gains in foreign currency value.

Forward markets exist in any currencies and for any maturities that banks are willing to offer. Most of the forward contracts used in the United States involve exchanges of US dollars for euros, Japanese yen, British pounds, Swiss francs and Canadian dollars. Maturities tend to be six months or less, though single-year and multiyear forward contracts are sometimes available.

The futures market in currencies

A very similar type of instrument is available on several securities exchanges in the United States and abroad. The foreign exchange futures contract is an agreement to buy or sell a fixed amount of foreign currency for delivery at a fixed future date at a fixed dollar price. The main difference between futures and forward contracts in the United States is that futures contracts have fixed sizes (about \$50,000 to \$100,000, depending on the currency) and pre-established maturity dates. (All are 3-, 6-, 9-, or 12-month contracts maturing on the third Wednesday of March, June, September or December.) Also, futures contracts are available for only a few currencies (Canadian dollars, euros, Swiss francs, British pounds, Japanese yen, Mexican pesos, Australian dollars, and a few others), and only if a buyer and a seller can be found at the time.

The futures market at the Chicago Mercantile Exchange is currently very thin (that is, few contracts are traded) except for the three-month contracts denominated in Canadian dollars, euros, Swiss francs, British pounds and Japanese yen.

Futures contracts are more widely accessible to firms and individuals than forward contracts because of their smaller value and the margin requirements that enable brokers to obtain collateral from market participants. (However, the currently thin nature of this market does not allow participants the wide range of currencies and maturities that are available for large-scale transactions in the forward market.) The standard contracts available at the Chicago Mercantile Exchange (CME) are described in Table 7.4. Trading hours have been extended via the GLOBEX system, which permits worldwide access to CME contracts. In 2015, GLOBEX trading was available pretty much around the clock, around the world.

Foreign currency *options* are an additional instrument of the foreign exchange market in the United States; they offer participants the *right* to buy or sell foreign currency in the future rather than the obligation to do so. Foreign currency options are similar to foreign currency futures in the Unites States in that the contracts are for fixed quantities of currency to be exchanged at a fixed price in the future. The key difference is that the option may be *exercised* – that is, presented for currency exchange – at *any* time between its issuance and the maturity date, or not at all.[3]

Foreign exchange arbitrage involves simultaneous contracting in two or more foreign exchange markets to buy and sell foreign currency, profiting from exchange rate differences *without* incurring exchange rate risk. Foreign exchange arbitrage may be two-way, three-way, or intertemporal and is generally undertaken by large commercial banks that can exchange large quantities of money to exploit small rate differentials.

Table 7.4 Currency futures contract specifications at the Chicago Mercantile Exchange

	British pound (£)	Eurozone euro (€)	Japanese yen (¥)
Trading unit	£62,500	€125,000	¥12,500,000
Quotations	US$ per £	US$ per €	US$ per ¥
Minimum price fluctuation	0.0001	0.0001	0.000001
Value of 1 point	$6.25	$12.50	$12.50
Months traded	Six months in the March quarterly cycle (Mar., June, Sep., Dec.) *GLOBEX (ETH): Sundays: 5:00 p.m.–4:00 p.m. Central Time (CT) next day*		
Trading hours	*Monday–Friday: 5:00 p.m.–4:00 p.m.* CT the next day, except on Friday – closes at 4:00 p.m. and reopens Sunday at 5:00 p.m. CT CME ClearPort: Sunday–Friday 6:00 p.m.–5:15 p.m. (5:00 p.m.–4:15 p.m. Chicago Time/CT) with a 45-minute break each day beginning at 5:15 p.m. (4:15 p.m. CT) *OPEN OUTCRY (RTH): 7:20 a.m.–2:00 p.m.*		
Last day hours	9:16 a.m. Central Time (CT) on the second business day immediately preceding the third Wednesday of the contract month (usually Monday)		

Source: Adapted from Chicago Mercantile Exchange.

E-resources: http://www.cmegroup.com/trading/fx/

The simplest form of exchange arbitrage is two-way arbitrage, between any two currencies and between two places. Assume quotations for Swiss francs in the spot market on a particular date were:

At Bankers Trust in New York:	$0.91038/SF
At Bank of America in San Francisco:	$0.91158/SF
At Lloyds Bank in London:	$0.91398/SF

An **arbitrageur** can buy SF in New York and simultaneously sell them in London, making a profit of $0.0036/SF, or 0.37 per cent per transaction. While the percentage gain is small, it translates to $3,600 for every SF1 million traded, and it involves no exchange risk. By repeatedly arbitraging this price (exchange rate) differential, the arbitrageur will make a profit until the exchange rate differential drops below the transactions cost (that is, the telephone bill, plus the arbitrageur's salary, plus other relevant costs).

The same two-way arbitrage may also occur in the forward market or between forward and futures markets. From the quotations here, we see that

profitable arbitrage opportunities exist between the New York forward market and the Chicago futures market, as well as between the New York and San Francisco forward markets:

At Bankers Trust in New York: ¥109.00/$ for delivery in 90 days.

At Bank of America in San Francisco: ¥109.90/$ for delivery in 90 days.

At the Chicago Mercantile Exchange: ¥107.38/$ for delivery on the same day.

An arbitrageur can buy yen in New York and sell them in San Francisco, both for exchange in 90 days, and earn ¥0.9/$, or 0.77 per cent per transaction. Similarly, an arbitrageur can buy yen in Chicago and sell them in San Francisco, to make ¥1.62/$, or 1.4 per cent per transaction. The difficulties with the latter transaction are that contracts may not be available for the desired amount or maturity date and transaction costs are higher for the intermarket exchanges. Nonetheless, both transactions may be feasible and profitable, even after costs are considered.[4]

Active learning check

Review your answer to Active Learning Case question 1 and make any changes you like. Then compare your answer to the one below.

1 What exchange risk does Barclays have as at 31 December 2017?

Barclays has exchange risk on the various assets and liabilities that were on its books at year-end 2017. These include exposures of £6,153 million in US dollars and £2,127 million in euros, among others. (It is interesting to note that in the two previous editions of this textbook, these figures were fairly similar, showing that the bank has maintained a consistent approach over the years.) From Tables 7.1 and 7.2, it appears that these exposures may be from lending to corporations in the European Union and the United States (though this is not certain, since some other activities are missing from the table). These are net asset exposures, or long positions, since Barclays will receive future cash flows in these currencies, and their values may change in terms of British pounds.

DETERMINATION OF THE EXCHANGE RATE

Exchange rates are determined by the activities of the various actors described earlier. If one could calculate the supply and demand curves for each exchange market participant and anticipate government constraints on the exchange market, exchange rate determination would be fairly simple. The composite supply and demand for foreign exchange would be as depicted in Figure 7.1.

Lacking this information, the analyst can still rely on two fundamental economic relationships that underlie exchange rate determination. Note that this section considers only economic factors; government restrictions on the exchange market are ignored.

The two fundamental economic relationships are **purchasing power parity** and the **international Fisher effect**. The former posits that shifts in exchange rates will occur to offset different rates of inflation in pairs of countries, and the latter proposes that exchange rates will shift to offset interest rate differentials between countries.

Purchasing power parity

The purchasing power parity (PPP) theory[5] is based on the law of one price and explains the long-run exchange rates. If two countries produce an identical product and transportation costs are extremely low, the price of the product should be the same in two countries. Under the law of one price, the price of the product is the same not only in two countries but also around the world. If a standard ton of polyurethane plastic costs \$200 in the United States and €190 in Germany, PPP requires an exchange rate of \$1.05/€. The same

reasoning could be used for all products whose production processes are equivalent in two countries and that are traded between these countries. The exchange rate that comes closest to simultaneously satisfying all of these equilibrium conditions is the PPP rate – a rate that equates the internal purchasing power of the two currencies in both countries.

Assuming we begin from that exchange rate, what will happen if Germany's inflation is 5 per cent and the US inflation is 10 per cent in the following year? PPP requires that the exchange rate adjust to eliminate this differential. Specifically, it requires that:

$$\frac{1 + \mathrm{Infl}_{\mathrm{US}}}{1 + \mathrm{Infl}_{\mathrm{Ger}}} = \frac{\mathrm{XR}_{t+1}}{\mathrm{XR}_t}$$

where:

Infl = inflation rate

t = time period

This means that inflation in the United States relative to inflation in Germany should be the same as the future exchange rate compared to the spot exchange rate. The relationship can also be written in a form similar to the interest parity equation by rearranging terms:

$$(1 + \mathrm{Infl}_{\mathrm{US}}) = (1 + \mathrm{Infl}_{\mathrm{Ger}})\frac{\mathrm{XR}_{t+1}}{\mathrm{XR}_t}$$

Purchasing power in each currency will be retained if:

$$\mathrm{XR}_{t+1} = \frac{1.10}{1.05}(\$1.05/€) = \$1.10/€, \text{ or } €0.909/\$$$

International Fisher effect

The international Fisher effect (IFE) translates Irving Fisher's reasoning about domestic interest rates to the transnational level. Fisher showed that inflation-adjusted (that is, 'real') interest rates tend to stay the same over time; as inflation rises or falls, so do nominal (**unadjusted**) **interest rates**, such that **real interest rates** remain unchanged. At the transnational level, nominal

national interest rates are expected to differ only by the expected change in the national currency's price (that is, the exchange rate). The international Fisher effect thus concludes that interest differentials between national markets will be eliminated by adjustments in the exchange rate. In terms similar to PPP, we see that:

$$\frac{1 + i_{US}}{1 + i_{foreign}} = \frac{XR_{t+1}}{XR_t}, \text{ or } (1 + i_{US}) = (1 + i_{foreign})\frac{XR_{t+1}}{XR_t}$$

where i = the interest rate, usually on a eurocurrency deposit denominated in the given country's currency.

If the eurodollar deposit rate is 3 per cent/year and the euro–euro rate is 6 per cent/year, the euro will be expected to devalue in the coming year by:

$$\frac{1.06}{1.03} = 1.029, \text{ or } 2.9 \text{ percent}$$

Notice that the international Fisher effect *will* operate in a free market, because investors will receive a higher return in euros otherwise. As more and more investors put their money in euros, the spot price of the euro will rise. Similarly, as US investors return their euro earnings to dollars at the end of the period (year), this increased demand for dollars will cause the euro to devalue (in the future). Thus, dollar and euro earnings will tend to be equalised.

Combined equilibrium relationships

The future exchange rate, XR_{T+1} will be partially determined by both of the above factors (PPP and IFE), which can be viewed in a general equilibrium context as shown in Figure 7.3. This figure also demonstrates the interest parity relationship, which provides another link between current and future currency values. Remember that these relationships are *equilibrium* economic conditions, which hold only approximately since substantial uncertainty exists about future conditions. Also, if a government intervenes to prohibit the

market from determining exchange rates, the relationships may diverge substantially from the equilibrium conditions. Figure 7.3 shows the main economic influences that, along with government policies and other factors, combine to determine exchange rates. Note that the expected exchange rate is in the top box, and the determinants of that rate (interest difference and inflation difference) are presented as fractions, so that they show the precise relationship between the spot exchange rate, XR_T and the expected future rate, $E[XR_T]$.

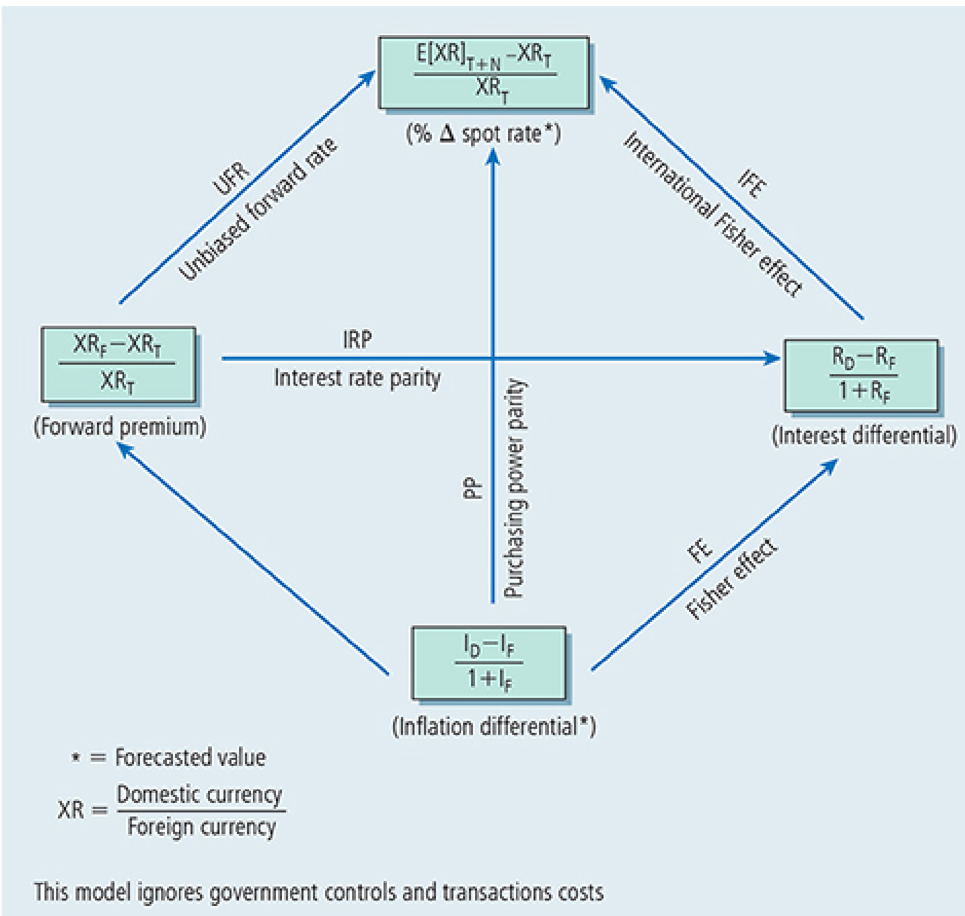

Figure 7.3 Exchange rate determination

A final caveat is in order. Despite the strong relationships among interest differentials, inflation differentials and exchange rates, other important *economic* influences operate in international finance. Pure speculation can

cause shifts in exchange rates, despite the fundamental economic conditions that have been described above. A country's balance of payments position may affect the exchange rate, even though that position also affects interest and inflation rates as well. Since the abandonment of the Bretton Woods system of fixed exchange rates, exchange rate determination has been extremely uncertain – perhaps similar to the determination of future values of stock exchange indexes.

Other factors determining exchange rates

PPP and IFEs explain overall exchange rate well, but other factors also determine exchange rates. In general, factors affecting the demand and supply of domestic products over foreign products determine exchange rates because these factors affect the demand and supply of local and foreign currencies in exchange rate markets. First, changes in demand affect the exchange rate. For example, the changes in trade barriers, such as tariffs and quotas, can affect the exchange rate. If the United States raises the tariff rates over Chinese products due to anti-dumping or countervailing regulation, the demand for domestic products increases over Chinese products and the US dollar tends to appreciate. Second, the changes in supply affect the exchange rate. For example, China becomes more productive than before. Chinese auto manufacturers recently developed their own models and produced them with great productivity, and the Chinese auto manufacturers can lower the price over foreign auto manufacturers. This affects the demand for Chinese automobiles, and the Chinese currency tends to appreciate. Third, national governments reserve foreign currencies and actively control foreign exchange rates to lower the price of exporting goods, to stabilise exchange rate volatility, and to protect the national economy from a currency crisis.

Active learning check

Review your answer to Active Learning Case question 2 and make any changes you like. Then compare your answer to the one below.

2 What should Barclays' expectation be about the value of the pound relative to the euro or the dollar?

Barclays can forecast the value of the euro or the dollar based on PPP, the IFE or a chartist method, in addition to simply using the forward exchange rate. Since Barclays' business includes currency trading, the bank probably should use one or more methods for the minute-by-minute activity in the foreign exchange market, and another method or methods for its longer-term concerns such as future maturities of loans and accounting reporting periods. In sum, Barclays should forecast using market-based tools such as IFE and PPP, as well as using additional methods such as technical forecasting or leading indicators for short periods of time such as hours or a few days.

PROTECTING AGAINST EXCHANGE RISK

Exchange risk is a very real concern for financial managers, whether or not their firms are directly involved in international business. The fact that the prices of imported products and services often vary with the exchange rate means that a local firm's costs may depend on the exchange rate. Similarly, if any of the firm's sales are exported, its earnings may vary as foreign sales change due to exchange rate changes. Even a purely domestic firm faces these problems, since suppliers and competitors that *are* doing international business will adjust to exchange rate changes, and this will affect the domestic firm.

From this perspective, exchange risk is *not* the risk that a local currency will decrease in value (devalue) relative to the home currency. *Exchange risk is the possibility that a firm will be unable to adjust its prices and costs to exactly offset exchange rate changes.* Thus, a US importer which faces 10 per cent higher costs because of a dollar devaluation from €0.80/$ to €0.72/$ still has no exchange risk as long as the importer can raise its own prices by 10 per cent without lowering total sales. (This result is the microeconomic version of PPP.) The problem may be viewed as one of 'passing through' cost increases to the firm's customers via higher sales prices.

Similarly, the appropriate measure of exchange risk for financial instruments is the firm's possible loss or gain in purchasing power from exchange rate-adjusted interest rates. Investing in a US dollar account that pays 5 per cent per year is better than investing in a Swiss franc account that pays 10 per cent per year if, during the year, the franc devalues by 6 per cent.

Alternatives to minimise exchange risk

Exchange risk exists whenever the firm's prices and costs cannot be exactly adjusted to offset changes in the exchange rate. Let us now consider a group of alternatives that will allow a firm to minimise (or at least reduce) its exchange risk. These alternatives fall into four categories:

1. Risk avoidance
2. Risk adaptation
3. Risk transfer
4. Diversification

INTERNATIONAL BUSINESS STRATEGY IN ACTION

The Big Four

The root of today's accountancy practices can be traced back to the Companies Act of 1900, a piece of legislation requiring all firms to undergo an annual audit, thus providing shareholders with a level of security that assertions about a company's financial performance were true and fair. Although accountancy was established as a profession by this time as a result of the growth of taxation since the turn of the nineteenth century, it was this legislation that really provided a level of consistency and allowed accountancy firms to flourish.

Unsurprisingly, the industry was quite fragmented, and despite many of the early firms hailing from Scotland, it wasn't long before London came to dominate. The 1920s and 1930s saw a series of mergers and acquisitions, and as there were fewer audits to be done, competition within the market increased, further polarising the profession, which by this time was led by a handful of large firms. Since the 1960s further consolidation of the profession has resulted in the creation of the Big Four accountancy practices: PricewaterhouseCoopers, Deloitte, KPMG and EY, which not only hold the top position in the UK market, but also have strong international networks enabling them to service clients across the globe. Table 7.5 illustrates the size of the Big Four in the UK versus globally in terms of revenue, highlighting the dominance of these firms at both a national and an international level.

Table 7.5 also shows a consistent pattern across all four in terms of the size of their UK operations relative to their global operations. All derive between 10 and 13 per cent of global revenues from the UK market and employ between 5 and 9 per cent of their overall employees in the UK. Although we could argue that PwC has a slightly larger dependency on the UK market, the difference is marginal.

Table 7.5 The Big Four (2018)

Firm	Global revenue (2018)	Worldwide staff (2018)	UK revenue (% of global)	UK staff (% of global)
Deloitte	$43.2bn	286,200	$3,914m (11%)	17,000 (6%)
EY	$34.8bn	260,000	$2,854m (10%)	12,000 (5%)
KPMG	$29.0bn	207,050	$2,876m (12%)	13,500 (7%)
PwC	$41.3.0bn	250,930	$4,319m (13%)	22,000 (9%)

Note: UK Revenue (% of global) and EY UK staff based on 2014 data

Although by no means the only large accountancy practices, the Big Four are significantly larger than their peers with a combined UK fee income of over $13,650 million in 2015. The fee income of EY, the smallest of the group, came in at $2,790 million, in comparison to the Big Four's closest competitor, Grant Thornton, which raked in $772 million, and the Big Four firms typically have three times as many UK partners as their mid-tier counterparts. The contrast is evident, clearly distinguishing between the two levels of practices. Large accountancy practices, however, are fairly homogeneous in the services they provide to clients, and are typically comprised of Assurance (Audit), Taxation and Advisory departments, although they also have more specialised sub-departments, such as Transaction Services and Insolvency.

In recent decades, the number of firms requiring an audit has undergone drastic change. In 1991, those with a turnover of less than £1 ($1.5) million were exempt, but this had leaped to over £5.5 ($8.3) million by 2004. The year 2009 saw the threshold raised to £6.5 ($9.75) million, before a dramatic increase in 2015 when the threshold reached £10.3 ($15.4) million. It is therefore no surprise that as fewer firms are required to undergo a statutory annual audit, the number of practices providing the service has decreased. In the half a decade to 2013, there was an 11.2 per cent fall in the number of registered audit firms, and given that 98 per cent of firms in the UK have a turnover of less than £10 ($15) million, the outlook for audit is rather bleak. Of those which are still in need of a statutory audit, many are of the size where only the Big Four firms have the scale and resources to carry it out.

With dwindling audit income, accountancy practices are looking to diversify their service offerings, and advisory work appears to offer the greatest opportunity for growth. Advisory work such as consultancy is typically more bespoke and is tailored to the individual client, and although overheads may increase as a result, this type of work is typically more profitable for the provider. It is therefore unsurprising that consulting services are expected to experience growth. The latest figures from Deloitte appear to confirm this, as the firm's UK practice saw consulting revenues increase by 10.5 per cent on last year, in comparison to audit fees which rose by just 0.3 per cent.

Not all consulting growth is organic, with over 150 mergers or acquisitions taking place in the first seven months of 2015, and in the past quarter of a decade the Big Four alone have been involved in 75 deals. Notably, PwC acquired Booz & Co. while Deloitte and EY have picked up

firms such as MashUp and Silicon Roundabout respectively. KPMG has been particularly busy, accounting for 30 of these 75 deals, including its acquisitions of Boxwood and High-Point Rendel.

Many of these names, however, do not have a global reach, and although they add to the level of expertise of the Big Four, it remains to be seen to what extent they can help the Big Four to really dominate the global advisory and consulting sphere. With the Big Three, Bain & Co., Boston Consulting Group and McKinsey & Co., dominating the management consulting industry, the Big Four currently appear to be very cautious in their deals, primarily opting for smaller, cutting-edge organisations specialising in innovative areas such as technology and analytics. With the economy picking up, the market seems to be big enough for everybody, and with the future for consulting looking bright, it will be very interesting to follow the progress of the Big Four. Whether or not they will one day rival the Big Three remains to be seen, but if recent M&A activity continues, and if the Big Four turn their attention to acquiring firms that will stretch their brand, it is certainly a possibility.

The Big Four have undoubtedly moved away from traditional accounting, and although they still provide standard services such as audit, they are constantly evolving and developing new competencies; with fierce competition in the tier, innovation is obviously a differentiator for a firm. The development of consulting is not the only example of diversification, as recent years have also seen the development of legal services provisions enabled by the Legal Services Act of 2007, and firms are continually looking to expand their expertise and offerings. The Big Four are now undoubtedly multidisciplinary professional services firms, and they show no signs of stopping.

Websites: https://www.ey.com/en_gl/global-review/2018; https://www.linkedin.com/company/deloitte-uk; https://home.kpmg/uk/en/home/about/annual-review-2018.html; https://home.kpmg/xx/en/home/campaigns/2018/12/global-review.html; https://www.pwc.co.uk/who-we-are/annual-report.html.

Sources: Liz Fisher, 'Audit exemption threshold: what's the damage?', *ACCA*, 25 November 2015; Oliver Griffen, 'Businesses want to raise audit threshold', *Economia*, 30 April 2015; Gavin Hinks, 'Shrinking audit and KPMG SME offering means practice revolution', *Accountancy Age*, 1 May 2015; Richard Crump, 'EY snaps up Silicon Roundabout firm in latest advisory push', *Accountancy Age*, 18 August 2015; Harriet Agnew, 'Deloitte UK boosted by strong consulting growth', *Financial*

Times, 23 August 2015; Margaret Cameron-Waller, 'Opinion: consulting M&A deals among the Big Four could get big', *Accountancy Age*, 20 July 2015; 'Attack of the bean-counters', *The Economist*, 21 March 2015; Statista, 'Number of employees of the Big Four accounting/audit firms worldwide in 2015', 2015; PwC, *Annual Report*, 2014; PwC, *Facts and Figures*, 2015; PwC, *Global Annual Review*, 2015; Vincent Huck, 'KPMG UK revenues up 5% but profits are down', *International Accounting Bulletin*, 18 December 2014; EY, 'EY reports 2014 global revenues of US$27.4b', 26 September 2014, http://www.ey.com; Deloitte, 'Deloitte announces record revenues of US$34.2 billion', 2015, http://www2.deloitte.com; 'Top 50+50 Firms 2015', *Accountancy Age*, 2015; KPMG, *Annual Report*, 2014; 'Business profile: Ernst & Young', *Telegraph*, 19 May 2014; Deloitte, 'Deloitte UK', 2015, Deloitte 2018 Global Impact Report, PwC Global Annual Review 2018.

Risk avoidance

Exchange risk avoidance is the strategy of trying to avoid foreign currency transactions. A purely domestic firm can try to make all of its purchases from local suppliers of locally produced goods and make all of its sales to local buyers in competition only with other domestic firms. Obviously, this strategy is impractical, if only because all firms are affected by goods priced in foreign currency – automobiles, chemicals, steel, and so on. Also, there are very few industries that do not use imported materials, export some of their output, or compete with imported products.

Risk adaptation

Exchange risk adaptation offers a more realistic alternative for protecting the firm against exchange risk. This strategy includes all methods of 'hedging' against exchange rate changes. In the extreme, exchange risk calls for protecting all liabilities denominated in foreign currency with equal-value, equal-maturity assets denominated in that foreign currency. An illustration can best clarify this point.

Assume a French firm has contracted to buy $100,000 of machinery from a foreign supplier for use in its manufacturing operations. The purchase is payable in six months in US dollars. To eliminate foreign exchange risk completely, the firm may do two things. First, it may raise its own prices to customers once the six months pass to equate euro devaluation to price increase (note that this does *not* involve a foreign currency hedge). If this option is not available which is often the case, the firm may look to its other option: obtain some equal-value *dollar asset* maturing in 180 days. This may be as simple as depositing funds in a dollar-denominated bank account for six months or as arcane as arranging a swap of the dollar liability for some other firm's euro liability. Fairly standard methods of hedging an exposed dollar liability include:

- obtaining a dollar-denominated financial asset (for example, a time deposit or a Certificate of Deposit (CD)) that matures when the liability comes due;
- finding a buyer for your firm's products and agreeing to receive payment in US dollars for the same value and time as the liability;
- finding a bank that will contract to buy euros from you and sell you dollars at a price fixed today for exchange when the liability comes due (this is called a *forward contract*);
- agreeing with another (for example, North American) firm to exchange your dollar liability for that firm's (that is, its French subsidiary's) euro liability;
- contracting for any other equal-value, equal-maturity dollar-denominated asset that will offset the exposed liability.

The firm's goal in choosing among these methods is to minimise the cost of protection against exchange rate risk.

Risk transfer

The third strategy for reducing exchange risk is **exchange risk transfer**. This strategy involves the use of an insurance contract or guarantee that transfers the exchange risk to the insurer or guarantor. In many countries, the central bank offers exchange risk guarantees to importers and exporters of some products according to the bank's policies. Technically, though perhaps not realistically, any firm or government agency could issue a guarantee covering exchange rate changes to a local importer, at a price that would presumably reflect the risk.

Diversification

The final strategy for reducing exchange risk is **currency diversification**. Here a firm can reduce the risk of unexpected local currency devaluations by spreading its assets and liabilities across several currencies (for example, euros, Swiss francs and pounds in addition to US dollars). This strategy simply means, 'Don't put all of your eggs in one basket.' Domestically, a firm should deal with several suppliers and a variety of customers to reduce risk through diversification. Internationally, a firm should hold assets (and liabilities) in several currencies to reduce the impact of unexpected exchange rate changes.

The strategy that is probably most useful to the majority of firms is risk adaptation, or hedging. A key point of this section is to recognise that other alternatives may be used in many instances when hedging would be more expensive or otherwise less desirable. Nonetheless, the central problem in exchange risk management is hedging, and corporate treasurers should always be on the lookout for new instruments and techniques.

Active learning check

Review your answer to Active Learning Case question 3 and make any changes you like. Then compare your answer to the one below.

3 How should Barclays deal with the risk involved in its foreign currency positions?

As an international bank, Barclays is constantly becoming involved in foreign exchange transactions. The bank needs to have a policy for its traders and its other bankers as to how much exchange risk the bank is willing to tolerate before looking for protection. The bank presumably knows more than most people about what to expect in the foreign exchange market, and it is very likely that Barclays will choose to run exchange risk without hedging because of this knowledge. Still, the bank must limit its exposure, and the usual hedging techniques for banks are forward contracts and matching loans with deposits in the same currency.

FOREIGN MONEY AND CAPITAL MARKETS

In each country an MNE enters, it will be able to obtain some degree of access to local financial markets. The MNE will generally utilise such markets to perform necessary local financial transactions and often to hedge its local asset exposure through local borrowing (or its local liability exposure through local deposits or investments). But the MNE can also utilise local financial markets to obtain additional funding (or place additional funds) for its non-local activities. A Mexican firm, for example, may choose to borrow funds through its Houston affiliate to finance its local needs in Texas *and* finance some of its needs in Mexico.

Usually national financial markets are not fully accessible to foreign firms; they are largely reserved for domestic borrowers and lenders. In these cases, use of local financial markets must be supplemented by use of the financial markets in the country of the parent company or elsewhere. Typically, such problems arise in countries that impose exchange controls, which limit the MNE's ability to put needed funds in the affiliate.

MNEs and national money markets

The advantages MNEs obtain from entering national money markets as *borrowers* of funds stem from the portfolio effect of holding liabilities in more than one (fluctuating) currency and from the local risk hedging that occurs as the MNE moves to balance local assets, such as plant and equipment, with local liabilities, such as local-currency borrowing. Additional benefits may occur if the local government subsidises such loans through interest rate reduction, through tax breaks, or otherwise; a policy of this kind

may be offered to attract the MNE's investment. This may lower the whole MNE's cost of capital if the subsidy does not disappear and if the interest rate remains below the comparable home-currency rate during the borrowing period.

The advantages MNEs obtain from entering national money markets as *lenders* of funds stem from the portfolio effect of holding financial instruments in more than one currency. There may also be a gain from balancing local-currency assets and liabilities if an excess of local liabilities was held previously. In addition, local financial investments may be a necessary strategy when exchange controls or profit remittance limits exist; such investments offer the firm an outlet for retained earnings that yield interest. Sometimes an exchange control policy may make the local-currency interest rates higher than those available in other currencies (after adjusting for expected exchange rate changes). In these cases, higher-than-normal profits can be earned by investing funds in local instruments, although exchange controls may limit conversion of the profits into the home-country currency, or a government-imposed exchange rate change may wipe out the advantage.

MNEs and national capital markets

The advantages MNEs obtain from entering national capital markets as *borrowers* are similar to those obtained from entering national money markets. However, the opportunities are generally much more limited. Very few countries have substantially developed stock markets, and those that do usually restrict the issuance of shares by foreigners. A few exceptions exist, such as the United States, the UK, Germany and France, but even they serve only the largest and most creditworthy MNEs. National bond markets, when they exist, are also very restrictive. Thus far, virtually all of the **foreign bond**

issues have taken place in New York (called ‘Yankee bonds’), London, Switzerland, Germany and Japan (called ‘Samurai bonds’).

The **eurobond** market, which functions mostly outside the United States, is dominated by dollar issues, which constitute a large percentage of the total.

The advantages MNEs obtain from entering national capital markets as *lenders* come mainly from diversification and from higher returns that may be protected by exchange controls, just as in the short-term market. Since the national capital markets are generally small, opportunities to use them are quite limited for foreign as well as domestic investors. Of course, since the main currencies of interest to MNEs and other international investors *are* those of the few large industrial countries, opportunities in those national capital markets do exist.

REGIONAL MONEY AND CAPITAL MARKETS

The scope of financial markets and instruments previously was mainly domestic or fully international, but not regional. The European Union changed this by designing both a regional monetary system (the **European Monetary Union**, or EMU) and a regional currency unit (the Euro) for intergovernmental financial transactions in the European Union.

The eurocurrency market

A **eurodollar** is a dollar-denominated bank deposit located outside the United States. This simple statement defines the basic instrument called the eurodollar. (Eurodollars are *not* dollars in the pockets of people who live in Europe! They are deposit liabilities of banks.) The widely discussed eurocurrency market is simply a set of bank deposits located outside the countries whose currencies are used in the deposits. Since over half of the deposits are denominated in US dollars, it is reasonably accurate to call this the eurodollar market. Notice that the eurodollar market is not limited to Europe; very large eurodollar markets exist in Tokyo, Hong Kong, Bahrain, Panama, and other cities throughout the world. For this reason, the eurodollar market is sometimes called the *international money market*.

What is the significance of the international money market? Since the eurocurrency market rivals domestic financial markets as a funding source for corporate borrowing, it plays a key role in the capital investment decisions of many firms. In addition, since this market also rivals domestic financial markets as a deposit alternative, it absorbs large amounts of savings from lenders (that is, depositors) in many countries. In fact, the eurocurrency

market complements the domestic financial markets, giving greater access to borrowing and lending to financial market participants in each country where it is permitted to function. Overall, the eurocurrency market is now the world's single most important market for international financial intermediation.

This market is completely a creation of the regulatory structures placed by national governments on banking or, more precisely, on financial intermediation. If national governments allowed banks to function without reserve requirements, interest rate restrictions, capital controls and taxes, the eurocurrency market would involve only the transnational deposits and loans made in each country's banking system. Instead, national governments heavily regulate national financial markets in efforts to achieve various monetary policy goals. Thus, the eurocurrency market provides a very important outlet for funds flows that circumvent many of the limitations placed on domestic financial markets. Many national governments have found the impact of the eurocurrency market on their firms and banks to be favourable, so they have allowed this market to operate.[6]

Since the eurocurrency market is a creation of the regulatory structure, it may be helpful to think about the key underpinnings of the system that allow eurodollars. Essentially three conditions must be met for a eurocurrency market to exist. First, some national government must allow foreign currency deposits to be made so that, for example, depositors in London can obtain dollar-denominated time deposits there. Second, the country whose currency is being used – in this example, the United States – must allow foreign entities to own and exchange deposits in that currency. Third, there must be some reason, such as low cost or ease of use, that prompts people to use this market rather than other financial markets, such as the domestic ones.

A wide range of countries allow foreign currency deposits to be held in their banking systems. Many of them impose restrictions (interest rate limits,

capital controls, and so on) on these as well as on local-currency deposits, so that a free market does not exist. Other countries, including most of the developed countries and many of the newly industrialising countries, allow foreign currency deposits that are not subject to the regulations placed on domestic deposits. In such countries, participants find more favourable interest rates, greater availability of funds and greater ease of moving funds internationally. These countries tend to be the euromarket centres.

Only a few currencies have become popular as eurocurrencies. Generally, these are the ones used widely in international trade – the US dollar, the euro, the British pound and the Japanese yen. The governments of all the nations whose currencies are being used have consented (or, more accurately, have not objected) to allowing foreign banks, companies and individuals to hold and use deposits denominated in those currencies. This may appear to be a trivial point, but any limitation on non-residents' use of dollar (or other eurocurrency) deposits would quickly eliminate that currency from the euromarket.

Eurocurrency interest rates

The base interest rate paid on deposits among banks in the eurocurrency market is called **LIBOR**. (Outside London, which is the centre of the entire euromarket, the base rate on deposits is generally slightly higher.) LIBOR is determined by the supply and demand for funds in the euromarket for each currency. Because participating banks could default (and, infrequently, do default) on their obligations, the rate paid for eurodollar deposits is always somewhat above the domestic Treasury bill rate. Also, because domestic banks must comply with Federal Reserve requirements, they offer slightly lower deposit rates than unregulated eurobanks. The history of the LIBOR rates is shown in Figure 7.4.

The lending rate has no name comparable to the prime rate, but it is determined as LIBOR plus some margin, or spread, charged to the borrower. Banks generally do not require compensating balances or other implicit charges in addition to the spread over LIBOR in the euromarket. This also helps reduce the cost of using the euromarket for borrowers. The total cost of borrowing in the euromarket for a prime US corporation historically was marginally below the domestic US prime rate. Because of competition among lenders in both markets, prime borrowers have been able to obtain the same rate in both markets since the early 1980s.

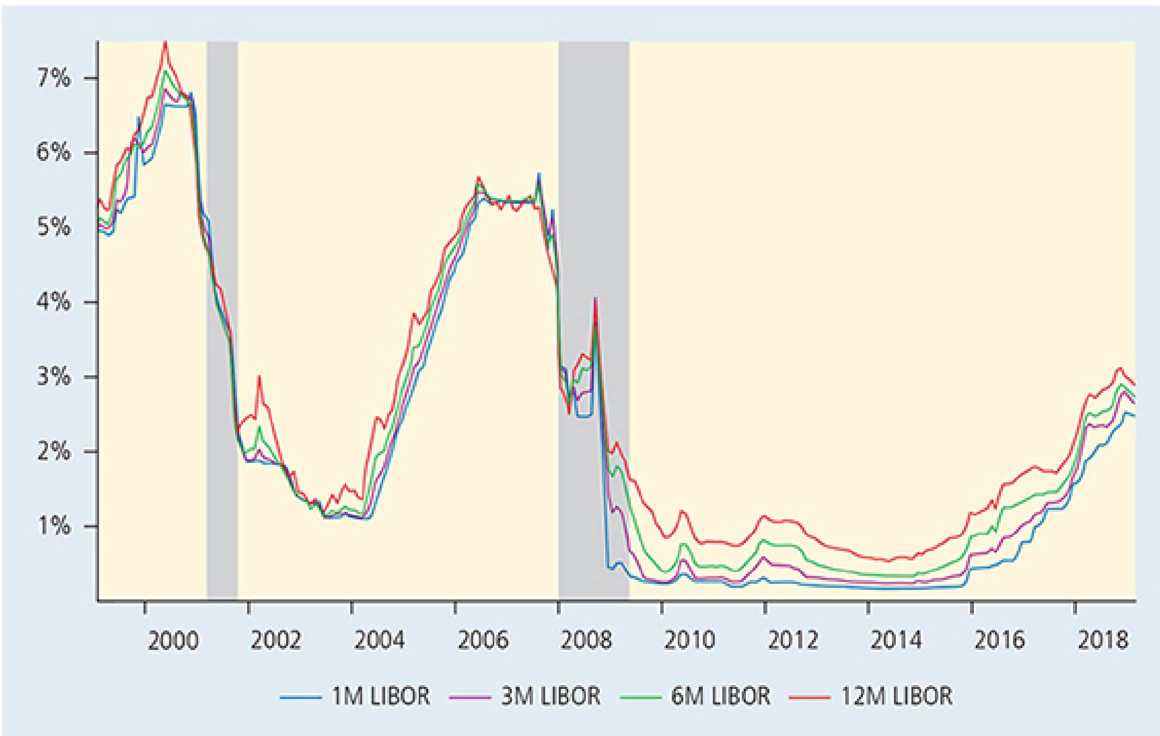

Figure 7.4 History of Libor rates, (2000–18)

Source: https://www.macrotrends.net/1433/historical-libor-rates-chart.

Interest rates on other eurocurrencies generally follow the same pattern, though when capital controls exist in a particular country (say, France), borrowing rates may be higher in the euromarket (which is not restricted) than in the domestic market.

Other market characteristics

Transactions in the eurodollar market generally involve $1 million or more, although in the past several years many deposits of $50,000 to $100,000 have been given at LIBOR, and loans of similar amounts have been offered at the analogous lending rates. The market is directly accessible to banks, which carry out about three-fourths of the total volume of transactions among themselves. Companies and individuals participate through their banks, generally at interest rates slightly less favourable than those offered among banks.

Criticisms of the euromarkets

Over the years, the eurodollar market has been criticised as contributing to worldwide inflation and creating major new risks in the international banking system. While neither claim has been proved (or disproved) conclusively, each is worth considering here.

Because the eurodollar market adds to the worldwide volume of dollar-denominated assets, it has been accused of increasing the global money supply beyond the control of the US authorities. This may be true to some extent, but a number of factors mitigate the total impact of eurodollars. First, eurodollars exist only as time deposits and certificates of deposit, never as demand deposits or cash. Hence, in the narrow definition of money that includes only cash and demand deposits, eurodollars do not even appear at all. Second, as already noted, about three-fourths of all eurodollars are interbank deposits rather than new credit to companies or individuals that may use it for capital investment and thus economic growth. Finally, the eurodollar deposits used by companies and individuals for investment and consumption probably replace other (for example, domestic) bank deposits that would have been used for the same purposes anyhow. All in all, eurodollars probably add slightly to the total volume of economic activity worldwide because they

provide a form of financial intermediation between depositors (savers) in many countries and borrowers (investors or spenders) in many countries that is more efficient than that of individual domestic financial markets.

On the issue of increased risk, it has been argued that the eurocurrency market has led to much greater extension of loans to troubled borrowers, such as the governments of less developed countries that found it virtually impossible to repay in the 1980s. Unquestionably, the eurodollar market provided the mechanism through which these governments borrowed most of the money loaned to them in the 1970s. It is not clear, however, that any other financial markets would have fared any differently in the absence of eurodollars.

✔ Active learning check

Review your answer to Active Learning Case question 4 and make any changes you like. Then compare your answer to the one below.

4 How can Barclays use the eurocurrency market in its international business, and will this help in dealing with the exchange rate problem?

Barclays can and does use the eurocurrency market for much of its international lending, since conditions in this market favour the large clients and banks with which Barclays deals extensively. Barclays can offer euro deposits for various maturities in various currencies to its clients, and the bank can use this market to find offsetting exposures such as loans or investments in those same currencies and maturities.

Eurobonds and euroequities

Eurobonds are the long-term analogue of euro currencies. They are issued in countries of convenience and denominated in currencies other than the local one. With eurobonds, *taxation* of the interest income that investors receive is a key concern, so most of them are issued in tax jurisdictions that do not impose taxes on such interest payments (for example, Luxembourg). Eurobonds, like domestic US bonds, are issued by corporations and government agencies. They may be convertible into equity, and they may have fixed or floating interest rates.

For the investor, the eurobond market offers these advantages: (1) all issues are structured to allow exemption from interest withholding tax on the income earned; and (2) the terms of eurobond issues are more varied than those of domestic bond issues. For example, eurobonds usually have shorter maturities than domestic bonds (five to eight years) and often have floating-rate interest payments.

Euroequities

Euroequities emerged in the London Stock Exchange as another long-term euromarket, analogous to domestic stock markets. As the name implies, euroequities are shares of publicly traded stocks traded on an exchange outside the issuing firm's home country. They are bought and sold in shares denominated in the firm's home currency, so both company performance and exchange rate performance affect the returns on investments in euroequities.

In the United States, a market for such issues has operated for many years through an instrument called the American Depositary Receipt (ADR), which is essentially a claim on a share of stock in the foreign stock exchange intermediated by a securities broker who issues the ADR.

INTERNATIONAL BUSINESS STRATEGY IN ACTION

AngloGold Ashanti

When it comes to international finance, one of the primary concerns of MNEs is the ability to raise capital through new stock offerings and bank loans. For many years this was a major problem for the Anglo American Corporation of South Africa (AAC), which operated gold mines in that country. During South Africa's apartheid period, trade sanctions, controls on exchange currency, and protectionism all combined to isolate the AAC from outside financial markets. Unable to do business in the international arena, the AAC focused on expanding its domestic operations by acquiring holdings in a variety of industries including automobiles, newspapers and vineyards.

As apartheid came to an end, however, there was a gradual liberalisation of both trade and investment. And as its opportunity to move into the international arena began to increase, the firm put its gold mining activities into a new subsidiary, AngloGold, and began restructuring its operations. Non-core businesses were sold off and the company began focusing heavily on the development of its gold and uranium mines. However, its profitability and performance were handicapped by the small size of the South African economy and the fact that the Johannesburg stock market was not very influential in the worldwide financial markets. In addition, the local currency, the rand, was weak and the company needed to tie its operations to a stronger currency.

Source: Joerg Boethling/Alamy Stock Photo

In response, AngloGold determined that it needed to link itself to the triad and expand its mining operations worldwide. As a result, in 1998 the company was listed on the New York Stock Exchange, and today it is also listed on the Ghana and Australian Stock Exchanges. The firm now has access to equity capital in the EU and North America, as well as Australia. In 2003 AngloGold merged with Ashanti Goldfields. Further growth meant that by 2017 the organisation encompassed 17 gold mine operations spread across ten different countries (Argentina, Australia, Brazil, DRC, Guinea, Ghana, Mali, South Africa, Columbia and Tanzania). In total, the firm generated $4.5 billion in revenue, in 2018 and had a workforce of over 25,000 employees.

While AngloGold Ashanti's main product is still gold, revenue is also derived from the sales of silver, uranium oxide and sulfuric acid, sold across a range of international markets.

Websites: www.anglogold.com; www.nyse.com

Sources: AngloGold, *Annual Report*, 2009, 2014 and 2018, and company web page.

Sometimes an MNE will lend money in the international money market. For example, if General Motors finds that there are limitations on the amount of profit that it can transfer out of a country, the company may invest in local financial instruments and thus gain interest on funds that would otherwise sit idle.

THE IMF SYSTEM

The last international financial market we will examine here may be viewed as either a very important framework for international financial dealings or a market that is generally irrelevant to private business managers. The **international monetary system** is a financial market in which only central banks and the **International Monetary Fund** (IMF, or 'the Fund') operate, so private business plays no active role in it. On the other hand, rules for international financial dealings among countries are often set at the IMF, and substantial international loan decisions are made between governments and the IMF. Thus, the rules of the game in the other international financial markets are sometimes influenced by IMF activities.

The international monetary system oversees the exchange rate regime that prevails among the major developed countries, whose currencies are used for the vast majority of international payments. The IMF negotiates with governments of debtor nations (usually less developed countries) for loans directly from the Fund and for loan conditions that are used, subsequently, as a basis for lending by private banks to these same borrowers. In addition, the IMF serves as an intermediary for emergency loans between member governments to cope with the capital flow or exchange rate crises that occur from time to time due to speculation in foreign exchange markets or other causes. All in all, the international monetary system plays an important role in determining the rules of the game for private companies and banks in some spheres of international business, so managers need to understand its functioning.

The IMF was designed in 1944 at a conference of the Allied nations held at Bretton Woods, New Hampshire. Its general purpose was to provide a

multilateral framework for avoiding international financial crises by establishing rules for national exchange rate policies and for adjustment to balance of payments disequilibria (discussed in the Appendix to Chapter 6). Fixed exchange rates were a fundamental base of the original Bretton Woods system. To join the IMF, a country was required to make a deposit of gold (25 per cent), plus its own currency (75 per cent), such that each member country's total deposit relative to the total of IMF deposits was roughly in proportion with its share of world trade. Then each member country received the right to borrow up to 200 per cent of its initial deposit at the Fund, in any currency, to help pay for imbalances such as the one mentioned above. The IMF system was subsequently changed *de facto* to a floating exchange rate system that allowed each country to leave the value of its currency free to change with market forces or to fix that value to some other currency.

The link between the dollar and gold was also later broken. The IMF's members agreed to create a new currency that the Fund would issue when authorised to do so by a vote of the members. This currency, called the **special drawing right (SDR)**, allows its holder to obtain (or draw) other currencies from the IMF (or from other members) when desired.

During the late twentieth century, SDRs became fairly widely used as a currency of denomination for private sector financial instruments such as bonds and long-term bank loans. Because the SDR has a value based on several currencies (see Table 7.6), it is more stable as a borrowing or lending tool than any individual currency.

When the dollar devalues relative to other widely traded currencies, so does the SDR – but only 41.7 per cent of the SDR's value is affected negatively. The rest of the SDR's value is based on pounds, yen and euros, and these currencies may rise or fall relative to the dollar in such a situation. Overall, the changes must net out over all currencies, and an instrument such as the SDR changes relatively little in value compared to any single currency.

The SDR is really a ‘basket’ of currencies whose value is generally more stable than that of any one of its components.

Just as the euro has gained wide acceptance as an instrument for denominating international financial transactions, so the SDR promises to maintain its acceptance as a risk-reducing instrument. (The SDR has the advantage of including the US dollar in the group of currencies that determine its value, whereas the euro is based only on European currencies.) At present, private sector investors and borrowers are using a much greater volume and value of euro-denominated instruments than SDR-denominated instruments.

Table 7.6 IMF special drawing rights (November 2015)

Currency	Weights determined in the 2015 review	Fixed number of units of currency for a 5-year period starting 1 October 2016
U.S. Dollar	41.73	0.58252
Euro	30.93	0.38671
Chinese Yuan	10.92	1.0174
Japanese Yen	8.33	11.9
Pound Sterling	8.09	0.085946

Source: https://www.imf.org/en/About/Factsheets/Sheets/2016/08/01/14/51/Special-Drawing-Right-SDR.

Unresolved problems with the IMF system

The IMF system today differs dramatically from the model established at Bretton Woods in 1944. Flexible exchange rates have been substituted for fixed ones; gold has been greatly reduced as an international monetary asset, and its link to the dollar has been severed; a new reserve currency, the SDR, has been created to increase world liquidity; and, perhaps most important, the US dollar is no longer the single base for the IMF system of value. These major changes have come in response to problems and crises that have occurred during the past 60 years – yet the IMF system itself survives. While

few people would argue that the IMF has led directly to greater international financial stability over its history, at least the system has been flexible enough to accommodate the various crises that have threatened it.

Several problems that remain in the system deserve note. First, there has always been an uncomfortable tension between the countries that want to utilise the IMF simply as a bank for reducing the negative impacts of balance of payments difficulties and the countries that want to utilise it to subsidise economic development. The 'link' between the IMF and development finance was originally delegated to the **World Bank** (the IMF's sister institution). Traditionally, the IMF has loaned funds only for short-term uses, sometimes extending to two or three years. In the early 2000s, the Fund retained its basic form, and the resources of the World Bank expanded to assist more heavily in economic development.

A second problem that continues to plague the Fund is the issue of exchange rate regimes. Even as the flexible rate system moves through its fourth decade, there are repeated calls for a return to fixed, or more tightly constrained, currency values. The evidence of the entire twentieth century tends to suggest that no matter what exchange rate regime prevails, if international trade relations are unstable and payments imbalances are substantial, no exchange rate regime will be able to solve the problem.

On the whole, the international monetary system plays an important role in all international financial dealings by being the focal point for establishing rules on exchange rates, exchange controls, intergovernmental loans and other official transactions. On a day-to-day basis, most international business people, especially in the triad countries, do not feel the international monetary system's impact.

MNEs AND INTERNATIONAL FINANCIAL MARKETS AND INSTITUTIONS

Whether or not a company or bank is involved in international trade, investment or other international business, it is important that its managers understand some of the key aspects of international financial markets. The eurocurrency market may offer a low-cost borrowing opportunity, or the eurobond market may provide an outlet for selling new debt to a wider group of investors. The international monetary system establishes a framework within which governments set international financial policies that may affect many firms. The money and capital markets in foreign countries may offer opportunities to multinational firms that operate in those countries. The foreign exchange market determines the cost and availability of foreign currencies, used in business by many firms. Finally, all of these markets influence the functioning of the markets for real goods and services, the ultimate use for all financial claims.

KEY POINTS

1. Foreign exchange is any financial instrument that can be used to carry out payment from one currency to another.
2. There are two major foreign exchange markets in the United States and the UK: interbank (including brokers) and futures/options (at stock and commodities exchanges). The most important participants in foreign exchange markets are banks – acting as traders, speculators, hedgers and arbitrageurs. Exchange rates are determined by the activities of these four groups.
3. Exchange rates are also influenced by purchasing power parity, interest rates and technical factors such as national economic statistics and seasonal demands.
4. There are a number of international finance strategies that can be of value to firms doing business overseas. Two of the most important are strategies for managing currency exchange rate risk and strategies for financing international operations.
5. The international monetary system is a market among central banks of the countries that belong to the International Monetary Fund (IMF). The IMF's objectives include the facilitation of balanced growth of international trade, the promotion of exchange stability, and the making of financial resources available to the members of the Fund.

Key terms

- **exchange risk**

- **foreign exchange**
- **eurocurrency**
- **exchange rate**
- **foreign exchange traders**
- **foreign exchange brokers**
- **spot rate**
- **forward rate**
- **arbitrageur**
- **purchasing power parity**
- **international Fisher effect**
- **nominal interest rate**
- **real interest rate**
- **exchange risk avoidance**
- **exchange risk adaptation**
- **exchange risk transfer**
- **currency diversification**
- **foreign bond**
- **Eurobond**
- **European Monetary Union (EMU)**
- **eurodollar**
- **London interbank offered rate (LIBOR)**
- **international monetary system**

- **International Monetary Fund (IMF)**
- **special drawing right (SDR)**
- **World Bank**

REVIEW AND DISCUSSION QUESTIONS

1 If your firm had a subsidiary in Japan and about 100 million yen in exposed assets (that is, plant and equipment), how would you protect it against exchange risk?

2 If you managed the European operations of a large US-based MNE, in what market(s) would you seek long-term funding? Why?

3 If the euro area's inflation is about 3 per cent per year and US inflation is about 2 per cent per year, what would you expect to happen to the euro/dollar exchange rate in the next few months? Why?

4 What is the difference between a eurobond and a domestic bond in the United States? Which one would you prefer to issue as a company manager? Which one would you prefer to buy as an investor? Why?

5 How can a firm such as Ajax Steel in Peoria, Illinois, utilise the eurodollar market to minimise its financing costs? This firm is a medium-size manufacturer with no foreign sales.

6 Assume that the interest rate on 12-month US dollar deposits in London is 2.6875 per cent per year and the rate on British pound deposits there is 4.1875 per cent per year. The spot exchange rate is US $1.93/£. What do you expect the exchange rate to be in one year?

7 If you were offered the opportunity to establish a deposit in London-denominated euros, would you choose that rather than a deposit in British pounds or dollars? Why or why not?

8 What are the important differences between the Bretton Woods fixed exchange rate system and the current IMF system? How do these differences affect the MNE manager?

9 How may the International Monetary Fund affect companies' activities in international business?

10 How would you hedge the value of your export sale of €10 million of computers to a French customer? You will be paid in 180 days in euros. On what basis would you choose among hedging methods?

REAL CASE

HSBC

Which bank is the world's largest? Prior to the merger of Citicorp and Travelers in 1998, it was the Hongkong and Shanghai Banking Corporation (HSBC). By 2018, HSBC was the world's seventh largest banking and financial services group and the UK's no.1 largest banking group. Formed in 1865 by a Scotsman in the then British colony of Hong Kong, HSBC grew to employ approximately 235,000 people in 130 countries, serving over 39 million customers (2018). In the process, it became the world's first truly global bank, offering a full range of financial services from retail to corporate banking to insurance and financial management. HSBC built this global business based on its strong Hong Kong base. The bank owns the Hongkong Bank and most of the Hang Seng Bank, giving it over 40 per cent of the market in the Hong Kong Special Administrative Region of China that was created on 1 July 1997.

Perhaps less well known is that HSBC is also the owner of the former Midland Bank chain in the UK, the Marine Midland and Republic New York Banks and Household Finance in the United States, and the Hongkong Bank of Canada. It has also acquired large banks in Latin America, including Banco Bamerindus in Brazil and Bital in Mexico. In all these cases HSBC greatly improved the efficiency of the underperforming local banks through better systems and processes. For some time HSBC has operated a branding strategy under the HSBC title and logo, 'the world's local bank'. This captures one of the central dilemmas of global firms – to be both large and dominant, while being sympathetic to the needs of local customers. Branding, however, is only a start.

Today HSBC is well developed across the triad regions of Asia, Europe and the Americas. It is a global bank in terms of assets, but not revenues. Its diversification strategy helped to insulate it from the Asian financial crisis of 1997–98.

There is an old saying that the best test of a business is how well it does in a downturn (because a 'rising tide floats all boats', the strong and the weak). Again, in the world financial crisis 2007–09, HSBC looked pretty resilient. HSBC reported revenue of US$142.069 billion and profits after tax of US$5.728 billion for 2008. Although revenue was down 3 per cent on a year earlier, that looked very

healthy compared to sickly peers such as Citigroup, UBS and Royal Bank of Scotland (RBS). RBS required a British government bailout.

HSBC partly thrived because of its strong presence in emerging markets including India, China, the Middle East and Brazil, cushioning it against the big losses it took in the US market due to the subprime mortgage crisis. From 2007, HSBC expanded into Japan, Korea, Vietnam and India by launching new branches and services. Profits in some of HSBC's Middle East businesses, such as capital markets and private banking, were growing at a near 100 per cent.

Significant events in 2009 included its decision to sell landmark buildings in New York, London and Paris to raise cash. HSBC agreed to sell its London base at Canary Wharf to the National Pension Service of Korea for $1.25 billion in cash and its New York headquarters to Israeli investment holding IDB Group for $330 million. HSBC sold its Paris building to private investors represented by French Properties Management for $573 million. HSBC would lease back these buildings. Importantly, HSBC announced in 2009 that it was relocating the principal office of the Group Chief Executive to Hong Kong. This underscores HSBC commitments to emerging markets' businesses and reflects the historic shifts now taking place in the world economy. HSBC's corporate headquarters remain in the UK where it continues to benefit from being at the heart of the world's financial centres.

Its first-mover advantage as a truly global bank may prove hard for its competitors to match. There is constant pressure in banking to reduce costs through greater scale economies and improved information technology. HSBC is well positioned to continue as an industry leader because of its successful strategy.

In retrospect, one of the world's largest banks came from one of the world's smallest economies. And it did this despite the regulatory barriers to entry for foreign-owned firms in Europe and North America. As a result, HSBC is an example of a bank using modern management systems and market forces to win out over old-fashioned protectionism in a highly regulated worldwide industry.

Perhaps the biggest influence of HSBC and its efficient banking methods has been on British banking. Various restructurings in the early 2000s, including the acquisition of NatWest by the Royal Bank of Scotland and a merger of the Bank of Scotland and Halifax, led to closures of high-street bank branches and an early push towards online banking. Barclays and other banks were then

pressured by these restructured competitors to close branches, cut costs and increase operational efficiency. HSBC realised at this time that to be a successful international operation it needed not only to have wide geographic coverage but also to be able to offer efficient services.

More recently HSBC has worked to fundamentally change its culture under the leadership of António Simões, who became CEO of HSBC global private banking in 2018 and openly gay. He has pushed for greater diversity and inclusivity in the workforce and is strongly supportive of a family-friendly approach to management. This was reflected in the development of HSBC's UK head office, opened in Birmingham in 2018, separate from the global group HQ in London.

HSBC reported revenue of US $53.8 billion and profits before taxation of U$19.8 billion in 2018, as the largest bank in Europe. Presenting his first annual results, the HSBC chief executive, John Flint, said the fourth quarter had been 'undeniably weak' and that there were more risks to global economic growth ahead.

Websites: www.hsbc.com; www.citigroup.com; www.bankofscotland.co.uk; www.royalbankscot.co.uk; www.natwest.co.uk; www.barclays.com; https://www.theguardian.com/business/2019/feb/19/hsbc-warns-of-weak-global-economic-outlook.

Sources: 'HSBC: world's strongest bank', *Bloomberg Business Week*, 4 August 2008; 'HSBC to sell New York building for $330 million', *Bloomberg*, 10 October 2009; 'HSBC sells Paris building for $573 million', *Reuters*, 21 December 2009; HSBC, *Annual Report*, 2008–14; Lloyds, *Annual Report*, 2009; 'Fortune Global 500', *Fortune*, 2008, 2009, 2010, 2015 issues. 'HSBC's António Simões says being gay was key to career success', *Guardian*, 18 January 2015.

1 Since HSBC does business with the People's Republic of China and has substantial holdings of Chinese yuan (renminbi) on hand, what risk does this pose for the bank?

2 How could HSBC manage its currency exchange rate risk?

3 When British retail banks merged to achieve cost savings and economies, did this increase or decrease the barriers to entry for foreign banks wishing to do business in the EU?

REAL CASE

Slowdown in China: Global financial markets and contagion effects

In 2015, much of the media attention was focused on Greece’s financial meltdown. However, a crisis which may have a longer-term, global impact was actually occurring in China. Economists have reported the phenomena as ‘China’s 1929’, referring to the year of the largest stock market crash in history which resulted in the Great Depression era.

In late August 2015, the Chinese stock market witnessed a 30 per cent decrease in value – a figure similar to the UK’s entire economic output during 2014. This significant decrease had immediate consequences as it not only dragged down the Asian stock exchange but also the value of commodities too. Even though the Chinese government introduced a significant number of stimulus interventions, investors were not willing to invest in Chinese stocks. Furthermore, over 940 organisations suspended trading on China’s two main indices during this period. China’s media, who normally praise the Chinese economy, labelled the day ‘Black Monday’.

Prior to the Chinese stock market crash in August 2015 and before the events of China’s ‘Black Monday’, the Shanghai Composite Index (Figure 7.5) had generally been decreasing and Japan’s TOPIX Index (Figure 7.6) had generally been increasing. However, during the stock market crash both indexes fell, as the Shanghai Stock Exchange decreased by 8.5 per cent to a value of 3,210 and Japan’s TOPIX Index fell by 5.05 per cent to a figure of 1,480. Furthermore, Figures 7.7 and 7.8 illustrate the change in Hong Kong’s Hang Seng Index and Taiwan’s TAIEX Index respectively. In accordance with China’s stock market crash, Hong Kong’s Hang Seng Index and Taiwan’s TAIEX Index fell by 5.05 per cent and 4.8 per cent respectively. Furthermore, the Jakarta Stock Exchange Composite Index and Mumbai’s Sensex Index also dropped by 4.04 per cent and 4.55 per cent respectively. These demonstrate the ‘contagion’ effect, as national financial markets and local stock valuations reflect other nations’ ups and downs.

Figure 7.5 Change in the Shanghai Composite Index (2015–19)

Source: https://www.google.com/search?q=Shanghai+Composite+Index&rlz=1C1GCEA_enGB807GB807&oq=Shanghai+Composite+Index&aqs=chrome..69i57.2j0j7&sourceid=chrome&ie=UTF-8.

Figure 7.6 Change in Japan's TOPIX Index (2015–19)

Source: https://www.google.com/search?rlz=1C1GCEA_enGB807GB807&ei=T2a4XIj3K-HGxgPIoLmgDQ&q=Japan%E2%80%99s+TOPIX+Index&oq=Japan%E2%80%99s+TOPIX+Index&gs_l=psy-ab.3..0i71l8.0.0..29928. . . 0.0..0.0.0. . . . . . .0. . . . . . gws-wiz.utC9l1iJIT4.

Figure 7.7 Change in Hong Kong's Hang Seng Index (2015–19)

Source: https://www.google.com/search?rlz=1C1GCEA_enGB807GB807&ei=T2a4XIj3K-HGxgPIoLmgDQ&q=Hong+Kong%E2%80%99s+Hang+Seng+Index&oq=Hong+Kong%E2%80%99s+Hang+Seng+Index&gs_l=psy-ab.3..0j0i22i30l9.21517.22510..22573. . . 0.0..0.50.50.1. . . . . . 0. . . .1j2..gws-wiz. . . ..0..0i71.yChiHTNAvCg.

Figure 7.8 Change in Taiwan's TAIEX Index (2015–19)

Source: https://www.google.com/search?rlz=1C1GCEA_enGB807GB807&ei=pWa4XL77Mt2H1fAP9tyCmAo&q=TAIEX+Index&oq=TAIEX+Index&gs_l=psy-ab.3..0i67j0i7i30l2j0l3j0i30l4.1671.1671..1951. . . 0.0..0.53.53.1. . . . . . 0. . . .1..gws-wiz. . . . . . .0i71.vMtErMaNdCQ.

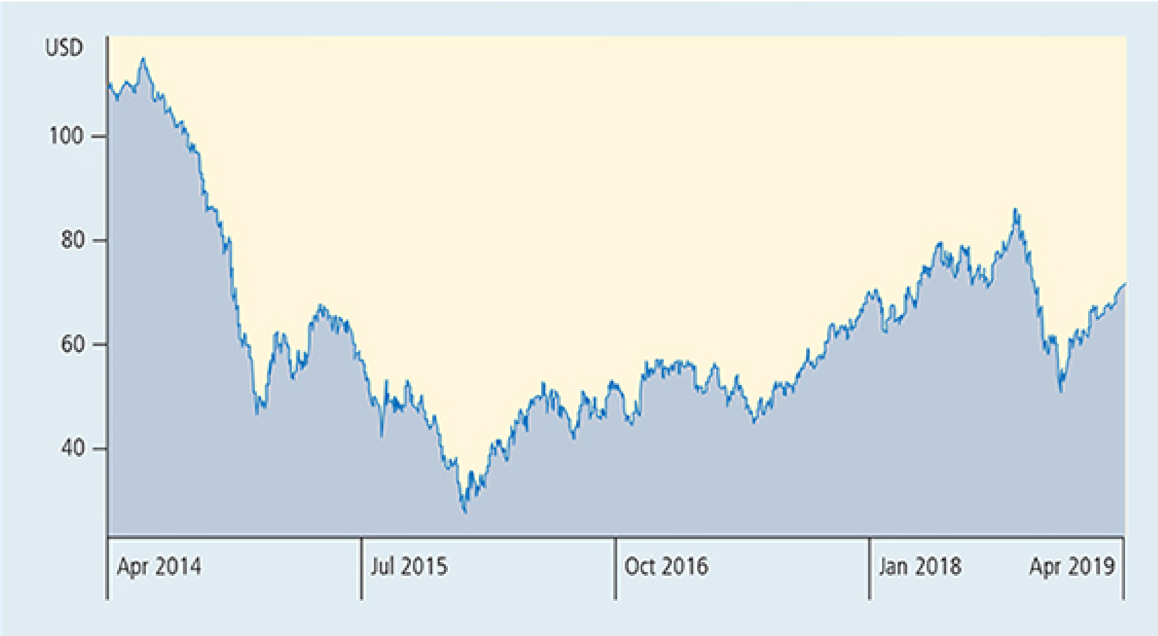

Figure 7.9 Change in the Brent oil price, 2014–19

Source: https://www.hl.co.uk/shares/trading-commodities/brent-crude-oil.

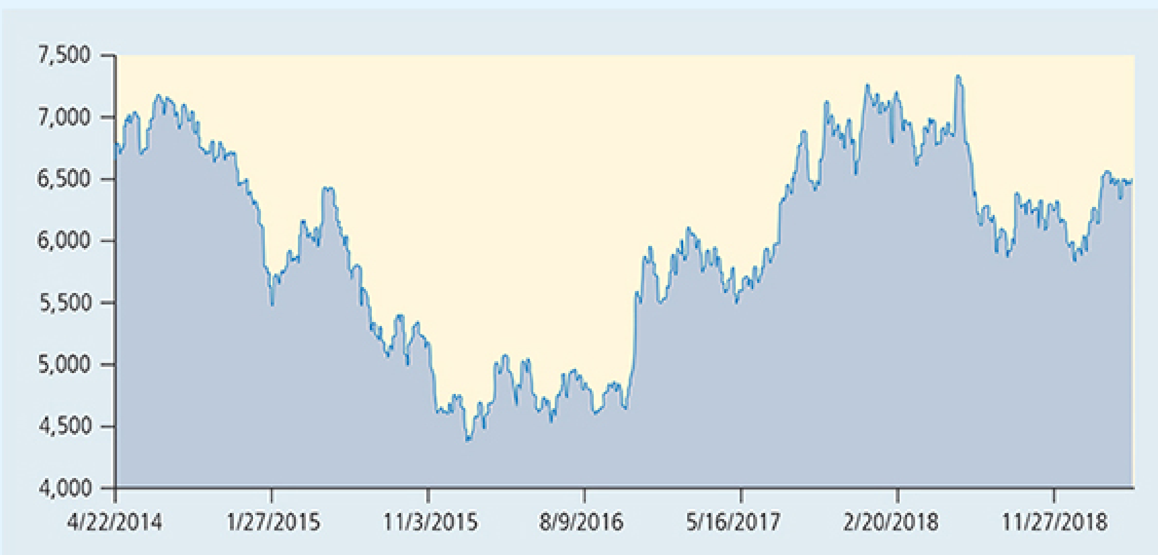

Figure 7.10 Change in the copper price, 2014–19

Source: https://markets.businessinsider.com/commodities/copper-price.

Even though Brent oil and copper prices were observed to have been generally declining in 2015, concerns regarding the future of China resulted in steeper falling demand for both commodities as the price of Brent oil fell to $45 and the average price of copper fell by 2 per cent. It is important to

note that after the crash the price of both commodities in 2015 were at a six-year low (Figures 7.9 and 7.10). The Chinese government pursued various strategies in an attempt to shore up the nation's $6 trillion stock market; however, declines in economic data clearly show these attempts as failing.

China is the world's second largest economy and any change there has the ability to significantly impact the global market. As a consequence, uncertainty over the fate of the Chinese economy, was partly to blame for a $90 billion fall in London's FTSE 100, in one day. The United States is also concerned about the Chinese economy because over 30 per cent of jobs which were created after the Great Recession era are export dependent, with China as the major new economy driving global trade. The total share of economic growth from emerging nations has significantly increased, from 20 per cent of the global GDP during the 1990s to over 40 per cent more recently, and China alone has accounted for approximately a third of this global growth.

Given the inter-connectivity across nations through trade and financial markets, there is no doubt that fluctuations in China's economy will have global repercussions, but analysts have been debating if the significant deterioration within the Chinese economy will inevitably drag the US economy down too. With the exception of the Shanghai Composite Index, most other indices generally continued to decline up until 2016, but slowly started to rise again and by 2019 they were above pre-2015 levels. However as evident in Figure 7.4, the Shanghai Composite Index has failed to recover to pre-2015 levels.

During the 1990s Asian financial crisis, many economists had predicted that there would be severe effects for the developed nations, particularly the United States. However, taking a glance at the US economy during the 1990s, it may be argued that these were some of the best years the American economy has witnessed. There are multiple reasons why the Asian financial crisis did not spread among developing nations; however, a significant factor was the fact that the Asian financial crisis was significantly related to the flight of capital from emerging markets, as they had mismanaged their currencies. Developing nations experienced difficult times during the Great Recession which started in the United States. However, as developing economies relied heavily on exporting goods to developed nations, the Asian financial crisis ultimately resulted in the return of investment capital to developed nations, which in turn boosted stock markets, lowered interest rates and caused growth to accelerate.

It is difficult to compare 1998 with the present, as Thailand and South Korea were clearly not such dominant forces in the global economy as China is now. Even though a deceleration in China's growth may have global repercussions, there are reasons to believe that this may not impact the United States too seriously. For instance, exports only account for 15 per cent of the nation's GDP and even if the United States were to experience a decline in trade by 10 per cent, it has been reported that this would only reduce US growth by 0.2 per cent.

The lessons?

It has been reported that the 2015 crash in China was similar to the US recession in 1929, as China today and the US in 1929 represent similar stages of economic development. For instance, the current rapid emigration of Chinese workers to industrial cities is similar to emigration trends of workers seeking jobs in steel and automotive manufacturing regions in the 1929 United States. With world record growth in development, China has managed to position itself as a nation with vast economic power. Many lessons have been learned since 1929, such as that the 'real' damage in a crash may not be the crash itself but the collapse of the banking sector. However, although stock markets may give advance warning of a credit crisis, many analysts are sceptical that China actually has a firm grasp on its banking sector. There is no doubt that a crash in the Chinese economy will have some global repercussions, but determining whether or not they will lead to a global economic meltdown depends on the response of China's policy-makers.

1. Discuss the impact of China's Black Monday on other markets in Asia.
2. Did Black Monday have an impact on global commodity prices?
3. Discuss whether Asian markets have recovered from the 2015 decline.

Sources: Jeremy Warner, 'The real worrying financial crisis is happening in China not Greece', *Telegraph*, 9 July 2015; Julia Kollewe and Angela Monaghan, 'Analysts fear China financial crisis as deflation looms', *Guardian*, 9 January 2015; Heather Timmons and Josh Horwitz, 'Charts: this may be the start of the world's next financial crisis', *Quartz*, 24 August 2015; *Bloomberg News*, 'Could China's yuan devaluation spark a new financial crisis?', 23 August 2015; Chris Matthews, 'Will the crisis in China sink the US economy?', *Fortune*, 2 September 2015; Julia Kollewe and Angela Monaghan, 'Analysts fear China financial crisis as deflation looms', *Guardian*, 9 January

2015; Lana Clements, ‘The five charts that show exactly why China’s economic crisis is terrifying’, *Express*, 20 September 2015; Lana Clements, ‘China crisis: Canada and Australia economies bitten by Beijing’s financial meltdown’, *Express*, 2 September 2015.

NOTES

1 Exchange rate quotations come as two-digit numbers, bid/asked, with the preceding numbers assumed. A British pound quote of 50/70 on a particular date, meant an actual price of:

$ 1.7950 bid to buy one British pound.

£ 1.7970 asked for selling one British pound.

The bank is offering (bidding) to buy pounds for $ 1.795 per pound and also offering (asking) to sell pounds for $ 1.797 per pound. Of course, the actual transaction will involve $1 million or more, to be exchanged at those prices.

Rates are typically quoted on the *Continental basis*, as units of foreign exchange per dollar, everywhere. US banks have traditionally used the *American basis*, quoting US$ per unit of foreign exchange. Clearly, whether the quote is SF2.0/$ or $0.50/SF, the value is the same. The *Wall Street Journal* offers both types of quotations, as shown in Table 7.2.

Another means used to distinguish the two ways of presenting an exchange rate is to call a quotation of domestic currency/foreign exchange an *indirect quote*. Conversely, a quotation of units of foreign exchange/domestic currency is called a *direct quote*. This system has more general applicability to any pair of currencies, whereas the American/Continental system relates only to rates involving the US dollar.

2 'Taking a position' means purchasing an asset (or a liability) denominated in a foreign currency without simultaneously matching it with a liability (asset) of the same value and maturity in the same currency. Realistically, if any one government disallows the euromarkets,

they can still function almost as effectively in other countries and currencies. At present, the US government has the most important role, since about 80 per cent of eurodeposits are denominated in US dollars. If a US bank buys Swiss francs, it takes a position in Swiss francs. When the bank sells those Swiss francs to a client, it eliminates the position.

3 A *foreign currency option* is a contract offering the holder the right to buy (namely, a *call option*) or sell (namely, a *put option*) a fixed amount of foreign currency for a fixed price during a fixed time period. The buyer of a call option on British pounds obtains the right to buy £31,500 at a fixed dollar price (that is, the *exercise price*) at any time during the (typically) three-month life of the option. The seller of the same option faces a *contingent liability* in that the seller will have to deliver the British pounds at any time if the buyer chooses to exercise the option.

The market value (that is, the price on 'premium' that the buyer must pay to purchase the option) of an option depends on its exercise price, the remaining time to its expiration, the exchange rate in the spot market, and expectations about the future exchange rate. An option may sell for a price near zero, for thousands of dollars, or for anywhere in between. Notice that the buyer of a call option on British pounds may pay a small price to obtain the option but does *not* have to exercise the option if the actual exchange rate moves favourably. Thus, an option is superior to a forward contract having the same maturity and exercise price because it need *not* be used, and the cost is just its purchase price. However, the price of the option is generally higher than the expected cost of the forward contract, so the user of the option pays for the flexibility of the instrument.

4 Yet another kind of foreign exchange arbitrage involves comparing interest rates on similar investments between two currencies. Interest arbitrage is the choice of investing, say, $1 million in a eurodollar bank

deposit, versus investing the same money in pounds, depositing in a europound deposit, and contracting a forward contract to convert back to dollars. This comparison can be used for whatever currencies may be available, and the investor benefits from taking the highest return available, with the exchange rates guaranteed through forward contracts (that is, with no exchange risk).

5 This entire discussion refers to *relative* purchasing power parity (PPP). The stronger, absolute version refers to parity in the values of factor inputs used in the production of products whose prices reflect relative factor productivities. Relative PPP considers only *changes* in the relative price levels between countries, not the initial (absolute) levels.

6 Realistically, if any one government disallows the euromarkets, they can still function almost as effectively in other countries and currencies. At present, the US government has the most important role, since about 80 per cent of eurodeposits are denominated in US dollars.

BIBLIOGRAPHY

Agmon, Tamir. 'Bringing financial economics into international business research: taking advantage of paradigm change', *Journal of International Business Studies*, vol. 37, no. 5 (September 2006).

Armstrong, Christopher S. et al. 'Market reaction to the adoption of IFRS in Europe', *Accounting Review*, vol. 85, no. 1 (2010).

Banalieva, Elitsa R. and Robertson, Christopher J. 'Performance, diversity, and multiplicity of foreign cross-listing portfolios', *International Business Review*, vol. 19, no. 6 (December 2010).

Bergh, Donald D. and Gibbons, Patrick. 'The stock market reaction to the hiring of management consultants: a signalling theory approach', *Journal of Management Studies*, vol. 48, no. 3 (May 2011).

Blome, Constantin and Schoenherr, Tobias. 'Supply chain risk management in financial crises – a multiple case-study approach', *International Journal of Production Economics*, vol. 134, no. 1 (2011).

Boehe, Dirk Michael. 'Strategic hedging: Evidence from Brazilian exporters', *Journal of World Business*, vol. 49, no. 3 (2014).

Boulton, Thomas J., Smart, Scott B. and Zutter, Chad J. 'IPO underpricing and international corporate governance', *Journal of International Business Studies*, vol. 41 (2010).

Bowe, Michael. 'International financial management and multinational enterprises.' In Alan M. Rugman (ed.), *Oxford Handbook of International Business*, 2nd ed. (Oxford: Oxford University Press, 2009).

Bowe, Michael, Filatotchev, Igor and Marshall, Andrew. 'Integrating contemporary finance and international business research', *International Business Review*, vol. 19, no. 5 (October 2010).

Brown, Craig O. and Dinç, I. Serdar. ‘Too many to fail? Evidence of regulatory forbearance when the banking sector is weak’, *Review of Financial Studies*, vol. 24, no. 4 (2011).

Campbell, John Y., Polk, Christopher and Vuolteenaho, Tuomo. ‘Growth or glamour? Fundamentals and systematic risk in stock returns’, *Review of Financial Studies*, vol. 23, no. 1 (2010).

Charupat, Narat and Miu, Peter. ‘The pricing and performance of leveraged exchange-traded funds’, *Journal of Banking and Finance*, vol. 35, no. 4 (2011).

Chen, Huifa, Tang, Qingliang, Jiang, Yihong and Lin, Zhijun. ‘The role of international financial reporting standards in accounting quality: evidence from the European Union’, *Journal of International Financial Management and Accounting*, no. 21, no. 3 (2010).

Connelly, Brian L., Hoskisson, Robert E., Tihanyi, Laszlo and Certo, S. Trevis. ‘Ownership as a form of corporate governance’, *Journal of Management Studies*, vol. 47, no. 8 (December 2010).

Cumming, Douglas and Walz, Uwe. ‘Private equity returns and disclosure around the world’, *Journal of International Business Studies*, vol. 41 (2010).

Doidge, Craig, Carolyi, Andrew and Stulz, Rene M. ‘Why do foreign firms leave US equity market?’, *Journal of Finance*, vol. 65, no. 4 (2010).

Eckert, Stefan, Dittfeld, Marcus, Muche, Thomas and Rässler, Susanne. ‘Does multinationality lead to value enhancement? An empirical examination of publicly listed corporations from Germany’, *International Business Review*, vol. 19, no. 6 (December 2010).

Eiteman, David K., Stonehill, Arthur I. and Moffett, Michael H. *Multinational Business Finance*, 12th ed. (Boston, MA: Pearson Addison Wesley, 2009).

Faccio, Mara. ‘Differences between politically connected and nonconnected firms: a cross-country analysis’, *Financial Management*, vol. 39, no. 3 (2010).

Forbes, Kristin J. and Warnock, Francis E. ‘Capital flow waves: surges, stops, flight, and retrenchment’, *Journal of International Economics*, vol. 88, no. 2 (2012).

Grosse, Robert. *The Future of Global Financial Services* (Oxford: Blackwell, 2004).

Hearn, Bruce, Piesse, Jenifer and Strange, Roger. ‘Market Liquidity and Stock Size Premia in Emerging Financial Markets: The Implications for Foreign Investment’, *International Business Review*, vol. 19, no. 5 (October 2010).

Hejazi, Walid and Santor, Eric. ‘Foreign asset risk exposure, DOI, and performance: an analysis of Canadian banks’, *Journal of International Business Studies*, vol. 41 (2010).

Hutson, Elaine and O’Driscoll, Anthony. ‘Firm-level exchange rate exposure in the Eurozone’, *International Business Review*, vol. 19, no. 5 (October 2010).

Hutson, Elaine and Stevenson, Simon. ‘Openness, hedging incentives and foreign exchange exposure: a firm-level multi-country study’, *Journal of International Business Studies*, vol. 41 (2010).

Ito, Kiyohiko and Rose, Elizabeth L. ‘The implicit return on domestic and international sales: an empirical analysis of US and Japanese firms’, *Journal of International Business Studies*, vol. 41 (2010).

Johnson, Robert and Soenen, Luc. ‘European economic integration and stock market co-movement with Germany’, *Multinational Business Review*, vol. 17, no. 3 (2009).

Lessard, Donald R. ‘Finance and international business.’ In B. Toyne and D. Nigh (eds.), *International Business: An Emerging Vision* (Columbia, SC:

University of South Carolina Press, 1997).

Li, Siqi. 'Does mandatory adoption of International Financial Reporting Standards in the European Union reduce the cost of equity capital?', *Accounting Review*, vol. 85, no. 2 (2010).

Lopez-Duerte, Cristina and Garcia-Canal, Esteban. 'Stock market reaction to foreign direct investments: interaction between entry mode and FDI attributes', *Management International Review*, vol. 47, no. 3 (2007).

Massa, Massimo and Zhang, Lei. 'Does corporate hedging attract foreign institutional investors? Evidence from international firms', *Journal of International Business Studies*, vol. 49, no.5 (2018).

Miller, Kent D. and Reuer, Jeffrey J. 'Firm strategy and economic exposure to foreign exchange rate movements', *Journal of International Business Studies*, vol. 29, no. 3 (fall 1998).

Oxelheim, Lars, and Randøy, Trond. 'The Anglo-American financial influence on CEO compensation in non-Anglo-American firms', *Journal of International Business Studies*, vol. 36, no. 4 (July 2005).

Pástor, L'uboš and Veronesi, Pietro. 'Political uncertainty and risk premia', *Journal of Financial Economics*, vol. 110, no. 3 (2013).

Purda, Lynnette D. 'Risk perception and the financial system', *Journal of International Business Studies*, vol. 39 (2008).

Radebaugh, Lee H., Gray, Sidney J. and Black, Ervin L. *International Accounting and Multinational Enterprises*, 6th ed. (Hoboken, NJ: Wiley, 2006).

Remmers, Lee. 'International financial management: 35 years later – what has changed?' *International Business Review*, vol. 13, no. 2 (April 2004).

Rugman, Alan M. *International Diversification and the Multinational Enterprise* (Lexington, MA: D. C. Heath, 1979).

Rugman, Alan M. 'International diversification and multinational banking.' In Sarkis J. Khoury and Alo Gosh (eds.), *Recent Developments in*

International Banking and Finance (Lexington, MA: D. C. Heath, 1987).
Rugman, Alan M. and Li, Jing (eds.). *Real Options and International Investment* (Cheltenham: Edward Elgar, 2005).
Santos, Tano and Veronesi, Pietro. 'Habit formation, the cross section of stock returns and the cash-flow risk puzzle', *Journal of Financial Economics*, vol. 98, no. 2 (2010).
Shapiro, Alan C. *Multinational Financial Management*, 9th ed. (New York: Wiley, 2009).
Song, Sangcheol. 'Exchange rate challenges, flexible intra-firm adjustments, and subsidiary longevity', *Journal of World Business*, vol. 50, no.1 (2015).
Strange, Roger, Filatotchev, Igor, Buck, Trevor and Wright, Mike. 'Corporate governance and international business', *Management International Review*, vol. 49, no. 4 (2009).
Tong, Tony W. and Reuer, Jeffrey J. 'Real options in multinational corporations: organizational challenges and risk implications', *Journal of International Business Studies*, vol. 38, no. 2 (March 2007).
Umutlu, Mehmet, Akdeniz, Levent and Altay-Salih, Aslihan. 'The degree of financial liberalization and aggregated stock-return volatility in emerging markets', *Journal of Banking and Finance*, vol. 34, no. 3 (2010).
Van Rooij, Maarten, Lusardi, Annamaria and Alessie, Rob. 'Financial literacy and stock market participation', *Journal of Financial Economics*, vol. 101, no. 2 (2011).
Yan, Shu. 'Jump risk, stock returns, and slope of implied volatility smile', *Journal of Financial Economics*, vol. 99, no. 1 (2011).
Zhao, Hua. 'Dynamic relationship between exchange rate and stock price: evidence from China', *Research in International Business and Finance*, vol. 24, no. 2 (2010).

Part Three

INTERNATIONAL - BUSINESS STRATEGIES

Chapter 8

MULTINATIONAL STRATEGY

Contents

Objectives of the chapter

Multinational enterprises (MNEs) are businesses that are headquartered in one country but have operations in other countries. MNE managers have to cope with both structural and strategic-

complexity which results from managing business activities across country borders, spanning different political, institutional, legal and cultural environments. Large MNEs do this by conducting a thorough analysis of their environments and often develop detailed, plans for coordinating worldwide activities, through a three-step process: formulation, implementation and control. Smaller MNEs may use less sophisticated plans. But for all international firms, survival depends on the ability to sense and adapt to the changes across all of these environments.

The specific objectives of this chapter are to:

1 *Define* the term *strategic planning* and discuss the strategic orientations that affect this planning process.

2 *Explain* how strategy is formulated, giving particular emphasis to external and internal environmental assessment.

3 *Describe* how strategy is implemented, with particular attention to location, ownership decisions and functional area implementation.

4 *Discuss* the ways in which MNEs control and evaluate their strategies.

ACTIVE LEARNING CASE

Vodafone and the triad telecom market

Founded in 1982, Vodafone is a London-based multinational telecommunications company. As of 2018, Vodafone was the world's second-largest cell phone company by revenue. With $53 billion in sales, of which 75 per cent was in Europe, it had a workforce of approximately 112,000 employees (China Mobile Communications with revenue over $100 billion and 851 million customers was the world's largest cell phone company in 2018). In 2018 Vodafone had approximately 470 million mobile customers around the world, operates a network in over 26 countries, and has a partner network in over 50 countries. Let's review its growth.

Vodafone expanded globally through a carefully crafted 'triad' strategy. From 1991 to 1998 its focus was on Europe, where it developed one of the basic ideas that it continues to use in most cases – acquire companies in association with partners and pay for it with equity. This strategy has given Vodafone access to new markets while providing it with partners that help deal with local regulatory environment agencies and provide assistance in addressing local market needs.

To appease EU regulators during its acquisition spree in the 1990s, Vodafone had to divest itself of Orange, the UK's third largest wireless operator. European acquisitions could not, therefore, be the company's only growth strategy. Rather, the best strategy was to go international, gain market share in all major economies, then link together all these firms into a worldwide network. This is precisely what it did.

Vodafone took a major step in implementing its worldwide strategy in June 1999, when it beat Bell Atlantic to buy AirTouch Communications, a California-based firm. Creating Vodafone AirTouch (VA) gave the overall company a market capitalisation of $154 billion and a total of 35 million wireless customers worldwide. Soon after the acquisition, VA entered into an agreement with Bell Atlantic (which was soon to merge with GTE) that gave it a 45 per cent stake in a venture called Verizon Wireless.

Source: ScottyH/Alamy Stock Photo

By 2001 the US market had relatively low penetration levels compared to Europe and Japan. Yet it had the highest potential for growth across industrialised countries. As of 30 September 2010, Vodafone's share in Verizon Mobile had 41.927 million subscribers compared to 38.9 million in 2001, a growth of 8 per cent over ten years. In 2010, Vodafone had 124 million customers in Europe. In geographic terms, 37 per cent of Vodafone's subscribers and 64 per cent of its turnover were in western Europe. In a major change to its strategy under CEO Vittorio Colao, Vodafone sold its shares in Verizon in 2014 for $130 billion, cutting its market value almost in half, to $100 billion. The core aim was to move away from all minority shareholdings and focus on investing in majority-owned acquisitions.

Japan represented the other arm of the firm's initial 'triad' strategy. Vodafone cemented its position in Japan in late 2001 by increasing its share of Japan Telecom to 69.7 per cent. By 2001, Vodafone had 10.4 million subscribers in Japan – 7.8 per cent of the company's total subscribers. Vodafone held operating control of Japan Telecom and also owned J-Phone, a large cell phone operator. But in 2006, Vodafone announced it would sell all its interest in Vodafone Japan to SoftBank for $15.4 billion, most of which was received in cash. Vodafone Japan later changed its name to SoftBank Mobile. In 2010, Vodafone sold its remaining minority interest in its Japanese operations and exited Japan, as part of its new strategy, 'offloading non-core assets'. Vodafone said it would focus on markets in Europe, India and Africa.

Vodafone had become a major player in the EU with holdings in Omnitel, Mannesmann and SFR. The company was a force in the US market through its minority holding in Verizon Wireless (until 2014). By 2010, Vodafone had ventured into other markets. In Australia and New Zealand, it had wholly owned subsidiaries and about 6.024 million subscribers. This represented 50 per cent growth over 10 years. In non-industrialised countries, where the risk is higher, it held minority interests in most of its operations. Only in Egypt did it have more than 50 per cent ownership. In South Africa, Kenya and Fiji, it held between 35 and 40 per cent. In China, the market with the largest potential growth, it held a mere 3.2 per cent ownership of the venture. In such a huge market, however, that accounted for nearly 5 million subscribers. In September 2010, Vodafone sold its stake in China's biggest operator, China Mobile, for $6.5 billion for cash, and achieved a near doubling of Vodafone's original investment. Vodafone continues to cooperate with China's leading telecommunication companies in areas such as roaming, network roadmap development, multinational customers and green technology.

In 2007, the company agreed to acquire a controlling interest of 67 per cent in Hutchison Essar Limited in India for US$11.1 billion. At the same time, it agreed to sell back 5.6 per cent of its Airtel stake back to the Mittals. Vodafone would retain a 4.4 per cent stake in Airtel. Hutchison was rebranded as Vodafone in India, but the firm faced a series of problems with the Indian tax authority, which claimed that Vodafone owed value added tax (VAT). Despite this, it had reached a market of 115.553 million mobile customers in India by 2010.

Vodafone's strategy is to maximise its footprint with a common technology and offer the largest possible 'roaming' wireless capability, which lends itself to overall lower costs. Perhaps surprisingly, this roaming technology was more prevalent in Europe than in the United States, mostly due to EU-wide cooperation between governmental regulatory authorities regarding common platforms.

Vodafone is not only relying on geographic diversification of acquisitions. Technology plays a major role in this industry, and Vodafone, like its competitors, purchased licenses to operate 3G and 4G technology. When the industry overestimated the pace at which the technology was being developed, some providers stumbled badly, but this technology also quickly became available in urban areas in Europe and Japan. More recently, in 2019 Vodafone UK, Qualcomm Technologies

Inc. and Ericsson started to conduct ‘over the air’ tests concerning 5G technology. 5G smartphones will enable consumers to stream exceptionally high-resolution videos and make gaming on the go more seamless than ever as web-browsing has been reported to be up to 10 times faster than 4G. Furthermore, 5G technology is essential if 3D holographic calls are to take off and Vodafone were quick to trial and display this form of technology in the UK in 2018.

The biggest challenge facing Vodafone will be that of coordinating all of its worldwide holdings so as to maximise shareholder value. In an effort to handle this problem, the company’s head office has now abandoned the use of centralised control and opted for a decentralised type of operation. In the United States, for example, local partners and operating managers now make many of the major decisions regarding how to do business. The same is true in Europe. Vodafone is realising that in order to manage all of these different units in worldwide markets where regulations and customer preferences are often quite different, the best approach is to create a strategic plan that recognises and takes advantages of these differences.

Websites: www.vodafone.com; www.verizon.com; www.omnitelvodafone.it; www.mannesmann.de; www.nttdocomo.com; www.kddi.com; https://www.rcrwireless.com/20190208/carriers/vodafone-uk-partners-qualcomm-ericsson-5g-lab-test

Sources: ‘Vodafone launches 3G in Europe’, *BBC News*, 4 May 2004; Vodafone, *Annual Reports and Accounts*, 1999, 2000, 2004, 2009, 2010, 2014, 2018. News release, ‘Vodafone announces first half 2010/2011 results and strategy update’, 9 November 2010. ‘Fortune Global 500’, *Fortune*, 26 July 2010 issue, http://money.cnn.com/magazines/fortune/global500/2010; ‘Vodafone pockets $6.5bn in China mobile sales’, *BBC News*, 8 September 2010; ‘Vodafone exits Japan and raises profit forecast’, *BBC News*, 9 November 2010; ‘Fortune Global 500: China mobile communications’, *Fortune*, 2015, http://fortune.com/global500/china-mobile-communications-55/; ‘Verizon sale cuts Vodafone value by half to $100 billion’, *Bloomberg*, 21 February 2014.

1 **Given the competitiveness of the environment, how much opportunity exists for Vodafone in the international cell phone market?**

2. **What type of generic strategy does Vodafone employ? Defend your answer.**
3. **What form of ownership arrangement is Vodafone using to gain world market share? Explain.**
4. **On what basis would a firm like Vodafone evaluate performance? Identify and describe two.**

INTRODUCTION

In this chapter we provide an introduction to the key concepts of strategic management relevant to both MNEs and small and medium-size enterprises (SMEs). We will review the rationale for strategic planning and the strategic orientation of firms (whether they are ethnocentric, polycentric, regiocentric or geocentric). We will examine the process of strategy formulation and review the five forces of industry competitiveness. We then apply this thinking to analysis of a firm's value chain. We consider the basic generic strategies of firms. We apply these concepts to the implementation of strategy and discuss how this applies to different modes of entry, such as wholly owned subsidiaries, strategic alliances and joint ventures. We will conclude with a section on the valuation of firm strategy and set the stage for discussion of relevant organisation structures in Chapter 9.

Before becoming immersed in these details of strategic management, you should be aware of the linkages of strategy and structure to the previous work in this textbook discussing the theory of the MNE. Figures 1 and 2 in the opening section 'Frameworks for this Book' are useful roadmaps for our approaches to understanding MNE strategy and structure. In particular, the firm and country framework outlined in the opening chapters can be used to illustrate the special nature of strategic management as it applies to MNEs. In terms of the FSA and CSA matrix explained in Chapter 2, it is useful to review cells 1 and 4 at this juncture.

Cell 1 is a situation with low FSAs but strong CSAs. In terms of strategic management the firm will build competitive advantages due to its home-country CSAs. For example, firms from Canada will build CSAs based upon natural resources. They will exploit CSAs in the forest products sector, in

minerals, and in cheap hydroelectric power. Firms from China will develop CSAs in manufacturing based upon cheap labour. Firms from India will develop CSAs in information technology based upon cheap skilled labour. Firms in the United States will develop economies of scale based upon the CSAs of its huge domestic market: such CSAs (in terms of scale economies) can then be exploited abroad. The challenge for MNEs is to combine the CSAs with strong FSAs, a situation in cell 3 of the FSA–CSA matrix. This chapter explores ways in which strategic management itself may be a type of FSA that can turn the CSAs of cell 1 into the combined country and firm advantages of cell 3.

In contrast, cell 4 of the FSA–CSA matrix is a situation of strong FSAs where these are independent of CSAs. This cell can best be described by the resource-based view (RBV) of strategy. The RBV is the basic theory of strategic management as explained in textbooks and papers, including: Barney (2007), Grant (2008), Meyer and Peng (2005), Kostova and Hult (2016) and Mintzberg et al. (1998). (These references are in the bibliography at the end of the chapter.) The core concept in the RBV is that a firm needs to develop a sustainable long-run competitive advantage or capability. This is often called the core competence of the firm. In terms of international business, the core competence is identical to the concept of an FSA as discussed in earlier chapters. In other words, the RBV is simply a more detailed examination of the nature, extent and strength of FSAs. The weakness of the pure RBV is that it is confined to cell 4 of the FSA–CSA matrix. In other words, it has no international component since CSAs are not relevant to a firm's success in cell 4.

Obviously, cell 3 of the FSA–CSA matrix is a most intriguing one. This is where country and firm effects are combined. Such complementary assets lie at the heart of the modern theory of the MNE in particular and international business in general. Cell 3 is a situation requiring the integration of firm and

country advantages in a sustainable and long-run manner. In terms of the RBV, cell 3 is a situation requiring dynamic capabilities. In terms of mode of entry theory, it is a situation where network analysis can be applied to explain the generation of FSAs by subsidiaries within the network of the MNE. Some cell 3 thinking can also be applied to analyse international joint ventures. But before proceeding to this depth of analysis, it is first necessary to review the basic issues of strategic management (in this chapter) and organisation structure (in the following chapter). We will return to aspects of the RBV and the nature of location-bound or non-location-bound FSAs in Chapter 10 when we introduce the concept of national responsiveness.

Strategic planning is the process of evaluating an enterprise's environment and internal strengths, identifying its basic mission and long- and short-range objectives, and implementing a plan of action for attaining these goals. MNEs rely heavily on this process because it provides them with both general direction and specific guidance in carrying out their activities. Without a strategic plan, these businesses would have great difficulty in planning, implementing and evaluating operations. With strategic planning, however, research shows that many MNEs have been able to make adjustments in their approach to dealing with competitive situations and either redirect their efforts or exploit new areas of opportunity. For example, as a result of losing market share in Europe for years, General Motors cut its European capacity in an effort to stem further losses.[1] By carefully formulating their strategic plans, many MNEs are better able to cope with the ever-changing challenge of worldwide competition.[2]

STRATEGIC ORIENTATIONS

Before examining the strategic planning process, we must realise that MNEs have strategic predispositions towards doing things in a particular way, which help determine the specific decisions the firm will implement. There are four such predispositions: ethnocentric, polycentric, regiocentric and geocentric. Table 8.1 lists each predisposition and its characteristics.

An MNE with an **ethnocentric predisposition** will rely on the values and interests of the parent company in formulating and implementing the strategic plan. Primary emphasis will be given to profitability and the firm will try to run operations abroad the way they are run at home. Firms trying to sell the same product abroad that they sell at home use this predisposition most commonly.

Table 8.1 Typical strategic orientations of MNEs

MNE orientation	Ethnocentric	Polycentric	Regiocentric	Geocentric
Company's basic mission	Profitability	Public acceptance (legitimacy)	Both profitability and public acceptance	Both profitability and public acceptance
Type of governance	Top down	Bottom up (each local unit sets objectives)	Mutually negotiated between the region and its subsidiaries	Mutually negotiated at all levels of the organisation
Strategy	Global integration	National responsiveness	Regional integration and national responsiveness	Global integration and national responsiveness
Structure	Hierarchical product divisions	Hierarchical area divisions with autonomous national units	Product and regional organisation tied together through a matrix structure	A network of organisations (in some cases this includes stockholders and competitors)
Culture	Host country	Home country	Regional	Global
Technology	Mass production	Batch production	Flexible manufacturing	Flexible manufacturing
Marketing strategy	Product development is determined primarily by the needs of the home-country customers	Local product development based on local needs	Standardised within the region, but not across regions	Global products with local variations
Profit strategy	Profits are brought back to the home country	Profits are kept in the host country	Profits are redistributed within the region	Redistribution is done on a global basis
Human resource management practices	Overseas operations are managed by people from the home country	Local nationals are used in key management positions	Regional people are developed for key managerial positions anywhere in the region	The best people anywhere in the world are developed for key positions everywhere in the world

Source: Adapted from 'Strategic Planning for a Global Business', *Columbia Journal of World Business*, summer 1985. Copyright © Elsevier Science & Technology Journals. With permission from Elsevier Science.

An MNE with a **polycentric predisposition** will tailor its strategic plan to meet the needs of the local culture. If the firm is doing business in more than one culture, the overall plan will be adapted to reflect these individual needs. The basic mission of a polycentric MNE is to be accepted by the local culture and to blend into the country. Each subsidiary will decide which objectives to pursue, based on local needs. Profits will be put back into the country in the form of expansion and growth.

An MNE with a **regiocentric predisposition** will be interested in obtaining both profit and public acceptance (a combination of the ethnocentric and polycentric approaches) and will use a strategy that allows

it to address both local and regional needs. The company will be less focused on a particular country than on a geographic region. For example, an MNE doing business in the EU will be interested in all the member nations.

An MNE with a **geocentric predisposition** will view operations on a global basis. The largest international corporations often use this approach. They produce global products with local variations and staff their offices with the best people they can find, regardless of country of origin. Multinationals, in the true meaning of the word, have a geocentric predisposition. However, it is possible for an MNE to have a polycentric or regiocentric predisposition if the company is moderately small or limits its operations to specific cultures or geographic regions.

The predisposition of an MNE will greatly influence its strategic planning process. For example, some MNEs are more interested in short-term profit and/or growth and change their product and service portfolio to fit changing markets. Others focus on a longer-term strategy that develops core competences in specific brands or technologies that they can leverage over a longer period.[3] Some are more interested in economies of scale and dominance through size that will allow them to compete on a price basis across the country or region, as opposed to developing a high degree of responsiveness to local demand and tailoring a product to these specific market niches. Some prefer to sell in countries where the cultures are similar to their own so that the same basic marketing orientation can be used throughout the regions. These orientations or predispositions greatly influence strategy. For an example of one approach to this, see the case **International Business Strategy in Action: Tesco at home and abroad**.

INTERNATIONAL BUSINESS STRATEGY IN ACTION

Tesco at home and abroad

The origins of Tesco can be traced back to when its founder, Jack ‘Slasher’ Cohen, began selling food from a cart in Hackney in 1919, gaining his nickname from his ‘stack ’em high, sell ’em cheap’ strategy. Since the opening of the first Tesco store in 1929, the company has flourished and generated approximately $78 billion in revenues and operates in eight countries across the globe, with 6,800 stores (including franchises) as of 2018. The UK is still the primary focus for the company, with 310,000 of its 440,000 employers working in Britain.

Over the decades, the retailer has built up a dominant market share in its domestic market, peaking at over 30 per cent in 2007 but later slipping back to 28 per cent when German newcomers Aldi and Lidl expanded across the UK. Cost-cutting initiatives that had worked in the past, such as the ‘Big Price Drop’ which led to profits of over US$5 billion in 2011/12, were no longer effective and in 2015, the firm reported a US$9 billion loss. Its internationalisation strategy was also producing mixed results.

Tesco in the US

First, the US-based segment of the business, Fresh & Easy, which Tesco had established in 2007 under the leadership of Sir Terry Leahy, was failing to recoup the investment which the company had made. After six years in the market, the decision was made to withdraw from the US, leaving Tesco US$2.5 billion worse off. Observers pointed to a number of factors underlying its failure in the US market. One of the reasons was Tesco’s focus on mid-sized shopping centres, whereas most American shoppers are used to larger-scale shopping centres. Tesco’s self-checkout machines did not work well with American customers and the company’s focus on its own-brand products meant there was not enough room to offer local shoppers their US favourites. Other details, like offering pre-packaged sandwiches instead of order in-store delis for shoppers to make custom-made sandwiches, which is the norm in US supermarkets, contributed to this failure.

Retail analysts have also argued that despite Tesco conducting extensive research before entering the US market, the firm significantly underestimated the challenges. It failed to appreciate

some key differences between the Americans and the British, just because they spoke the same language. The same observers note that this was not the case when Tesco entered new markets in Poland and China, where it appreciated the difference in shopping behaviours and adjusted its business model accordingly.

Tesco in Japan

Tesco's disappointing foray into the US market was not the first time it had called time on an international venture. Before this, in 2011, the firm announced that it was to exit the Japanese market and sell its stores to Aeon, a rival Japanese supermarket group. Having entered Japan in 2003 through the acquisition of C Two-Network convenience stores for about US$230 million, and despite having spent eight years trying to gain a foothold in the market, it had only managed to secure 1 per cent market share. In line with Clarke's strategy of focusing solely on those regions where Tesco had the ability to become market leader, the company decided to exit Japan.

Tesco's lack of success in Japan was partly due to its inability to keep up with rapid changes in local customer tastes. The retailer did alter its business model to match the consumer behaviours in Japan, but not significantly enough. Costs are particularly high for stores in Japan. High rents coupled with a complex and expensive supply chain squeeze margins. The Japanese also have a strong preference for eating fresh foods that are locally sourced, making bulk buying difficult. The *Financial Times* once commented on this, observing in an article that there is a complete difference in the radishes eaten in Kyoto compared to those in Hokuriku. Finally, Tesco's small start with only 129 stores meant it failed to compete and develop brand awareness effectively when up against firms like Aeon, with 1,900 stores.

Tesco in Korea

In contrast to its performance in Japan, Tesco's Korean business, Homeplus, was going from strength to strength. Homeplus, a joint venture with Samsung, had almost 1,000 stores and was servicing around 6 million customers every week. Market analysts attributed this success to local chief executive Lee Seung-han of Samsung, who had managed to integrate Tesco into the Korean

model and thus avoid the mistakes made by rivals Carrefour and Walmart. Korea was thriving, but all was not well on the home front.

Back in the UK

Back in the UK, the Big Price Drop had been coined the Big Price Flop by the media as rather than creating savings for the customer, prices on the shelves had actually increased. Tesco's large out of town supermarkets began to suffer as customer's habits changed, with people choosing to make smaller, more regular purchases at high street convenience stores. Meanwhile, discount retailers Aldi and Lidl were revolutionising the supermarket industry and sparking a price war. The incumbents – Tesco, ASDA, Morrisons and Sainsbury's – were losing ground, demonstrated by Aldi's market share increasing to 7.6 per cent and Tesco's reduction in market share to 27.4 per cent in 2018.

In particular, 2014 had been a challenging year for Tesco as pre-tax profits tumbled by 92 per cent to only US$160 million, accounting irregularities were uncovered, and the firm's credit rating was dropped to Baa2 by Moody's. By January 2015, it had again been downgraded, this time to 'junk' status. In the face of such strong competition from its German rivals, Tesco slashed its 90,000-product range by 30 per cent in an attempt to follow the simpler model of its key competitors and cut costs, and announced the closure of 43 stores, but it seemed that nothing was going to rescue Tesco from this black hole.

With debts of over US$30 billion as of February 2015, Tesco was reviewing its portfolio in an attempt to see if it could strengthen its balance sheet, and in September it announced the sale of its Korean business, Homeplus, for US$6 billion. Although this by no means fixed the problem of Tesco's remaining debt, it opened up a number of options for restructuring and a new strategy. In 2017, Tesco announced its intention to merge with the UK's largest food wholesaler, Booker Group, who own the Premier and Londis convenience store brands. Reported to cost around $4 billion, the deal was said to create the UK's leading food business, selling to approximately 700,000 convenience stores, grocers and pubs, By merging with Booker Group, Tesco increased operations beyond its traditional food retailing business to incorporate the restaurant and takeaway

business. This strategy was designed to increase Tesco's scope, ensuring that whether customers decide to eat 'in home' or 'out of home', the firm still benefits.

The announcement of Tesco to join forces with Booker Group clearly shows that Tesco are still keeping a close eye on competitors, both direct and indirect, and if given the choice Tesco will not sit back and wait for its dominant market position to be slowly eradicated by rivals. The UK's supermarkets are continually at war and under pressure to engage in new strategy development in order to survive, as many customers have turned their back on large superstores, preferring to shop at convenience locations or online. Importantly, Tesco are not the first of the 'Big Four' to merge with organisations from other business segments, as Sainsbury acquired Argos and Morrisons negotiated a deal with Amazon, highlighting a diversification trend within the industry.

Unfortunately, it doesn't seem that Tesco are out of the woods just yet; as they have continually reduced the opening times of 24-hour stores across the UK and closed Tesco Direct in 2018. Also it appears that the firm is suffering the effects of Brexit, as it pulls beer brands such as Amstel, Sol and Kingfisher from its shelves reportedly due to the repercussions in terms of price negotiations. Nevertheless, Tesco appears to be in a far better position than it was a few years ago. There is no doubt that Tesco intends on remaining a key player in the supermarket industry.

Sources: Denise Winterman, 'Tesco: How one supermarket came to dominate', *BBC News*, 9 September 2013; Kamal Ahmed, 'Tesco posts record £6.4bn annual loss', *BBC News*, 22 April 2015; Kamal Ahmed, 'Tesco sells South Korea stores for £4bn', *BBC News*, 7 September 2015; 'Tesco timeline – the retail giant's rise and fall', *Guardian*, 23 April 2015; Nils Pratley, 'Tesco's big price drop flop?', *Guardian*, 8 December 2011; Zoe Woods, 'Tesco admits defeat and pulls out of Japan', *Guardian*, 31 August 2011; Simon Goodley, 'Tesco names 43 stores to close in turnaround plan', *Guardian*, 28 January 2015; Andrea Felsted, 'Philip Clarke failed to build on Leahy legacy at Tesco', *Financial Times*, 21 July 2014; Adam Jones, 'Tesco announces retreat from Japan', *Financial Times*, 31 August 2011; Scott Campbell, 'Tesco credit rating cut again by Moody's', *Telegraph*, 16 June 2014; Lianna Brinded, 'Tesco, Sainsbury's, and Asda are being crushed by Aldi and Lidl', *Business Insider*, 30 June 2015; https://www.statista.com/statistics/300656/grocery-market-share-in-great-britain-year-on-year-

comparison/; https://www.ft.com/content/fd651c8e-1cbb-300d-ba69-8e69a0de508e; https://www.theguardian.com/business/2017/jan/27/tesco-booker-shoppers-takeover-londis-budgens; https://www.telegraph.co.uk/business/2017/01/27/food-suppliers-fear-fresh-pressure-tesco-swoops-booker/.

1 What were the advantages of Tesco adopting a joint venture in Korea?

2 What are the advantages of Tesco using an M&A to enter into Japan?

3 What are the potential reasons why Tesco struggled to expand to the United States and Japan?

STRATEGY FORMULATION

Strategy formulation is the process of evaluating an enterprise's external competitive environment (threats and opportunities) and internal assets, capabilities and competitive advantages (strengths and weaknesses). This typically begins with consideration of the external arena, since the MNE will first be interested in opportunities that can be exploited. Attention is then directed to the internal environment and the resources the organisation has available, or can develop, to take advantage of these opportunities.

External environmental assessment

The analysis of the external environment involves two activities: information gathering and information assessment. These steps help to answer two key questions: what is going on in the external environment; and how will these developments affect our company? One of the most common ways to do this is through **competitive intelligence**, which is the use of systematic techniques for obtaining and analysing public information about competitors. These data are particularly useful in keeping MNEs alert to likely moves by the competition.

Information gathering

Information gathering is a critical phase of international strategic planning. Unfortunately, not all firms recognise this early enough. In the case of Harley-Davidson, the large US-based motorcycle manufacturer, it was not until the Japanese began dominating the motorcycle market that Harley realised its problem. A systematic analysis of the competition revealed that the major reason for Japanese success in the US market was the high quality

of their products, a result of extremely efficient manufacturing techniques. Today, Harley is competitive again. It achieved renewed success because it rethought its basic business, reformulated company strategy, vastly improved product quality, and rededicated itself to its core business: heavyweight motorcycles.

There are a number of ways in which MNEs conduct an environmental scan and forecast the future. Four of the most common methods are: (1) asking industry experts to discuss industry trends and make projections about the future; (2) using historical industry trends to forecast future developments; (3) asking knowledgeable managers to write scenarios describing what they foresee for the industry over the next two to three years; and (4) using computers to simulate the industry environment and generate likely future developments. Of these, expert opinion is the most commonly used. The Japanese and the South Koreans provide excellent examples. Mitsubishi has more than 700 employees in New York City, where its primary objective is to gather information on US competitors and markets. All large Japanese corporations operating in the United States employ similar strategies. The same is true for large South Korean trading firms, which require their branch managers to send back information on market developments. These data are then analysed and used to help formulate future strategies for the firms.

Such information helps MNEs to identify competitor strengths and weaknesses and to target areas for attack. This approach is particularly important when a company is delivering a product or service for many market niches around the world that are too small to be individually profitable. In such situations the MNE has to identify a series of different niches and attempt to market successfully in each of these geographic areas. The information is also critical to those firms that will be coming under attack.

Information assessment

Having gathered information on the competition and the industry, MNEs then evaluate the data. One of the most common approaches is to make an overall assessment based on the five forces that determine industry competitiveness: buyers, suppliers, potential new entrants to the industry, the availability of substitute goods and services, and rivalry among the competitors. Figure 8.1 shows the connections among these forces.[4]

Bargaining power of buyers

MNEs examine the power of their buyers in order to predict the likelihood of maintaining these customers. If the firm believes buyers may be moving their business to competitors, the MNE will want to formulate a strategy for countering this move. For example, the company may offer a lower price or increase the amount of service it provides.

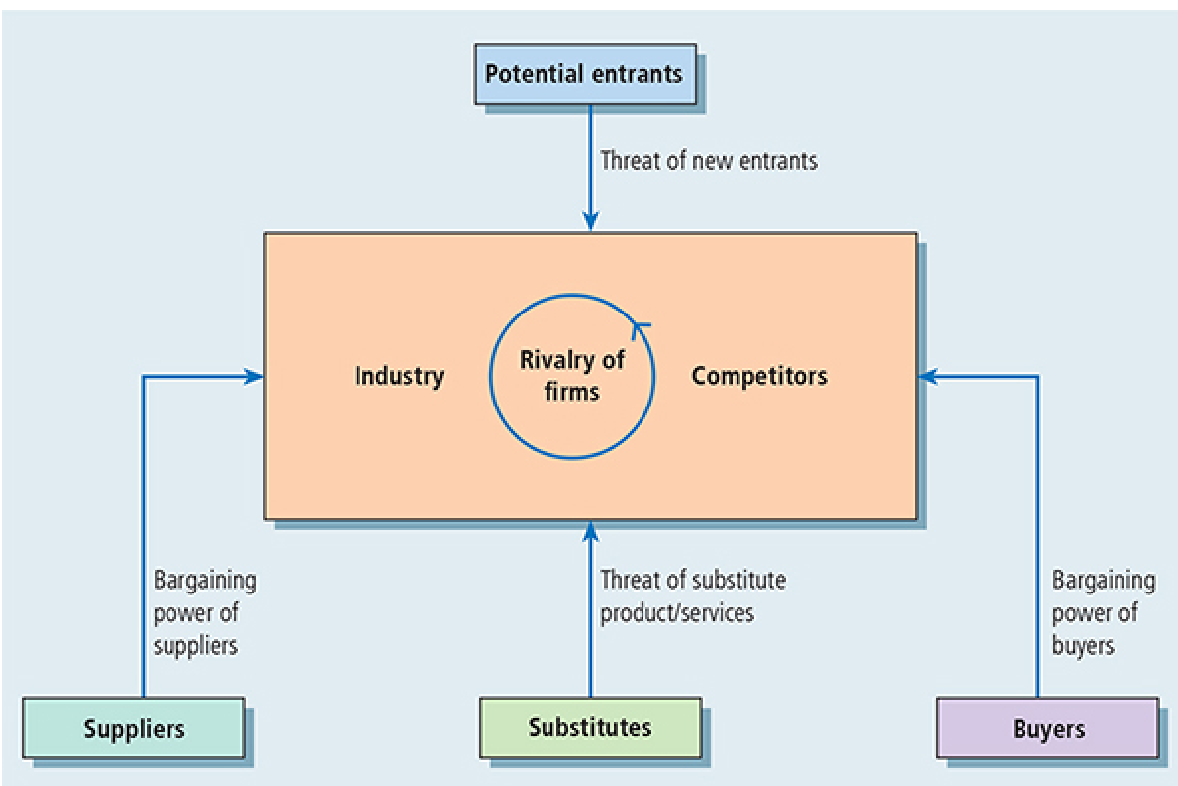

Figure 8.1 **The five forces of industry competitiveness**

Source: Adapted from The Free Press, an imprint of Simon & Schuster Adult Publishing Group, from *Competitive Advantage: Creating and Sustaining Superior Performance* by Michael E. Porter.

Bargaining power of suppliers

An MNE looks at the power of the industry's suppliers to see if it can gain a competitive advantage here.[5] For example, if there are a number of suppliers in the industry, the MNE may attempt to play them off against one another in an effort to get a lower price. Or the company may move to eliminate any threat from the suppliers by acquiring one of them, thus guaranteeing itself a ready source of inputs.

New entrants

The company will examine the likelihood of new firms entering the industry and will try to determine the impact they might have on the MNE. Two typical ways that international MNEs attempt to reduce the threat of new entrants are by: (1) keeping costs low and consumer loyalty high; and (2) encouraging the government to limit foreign business activity through regulation such as duties, tariffs, quotas and other protective measures.

Threat of substitutes

The MNE looks at the availability of substitute goods and services, and tries to anticipate when such offerings will reach the market. There are a number of steps the company can take to offset this competitive force, including: (1) lowering prices; (2) offering similar products; and (3) increasing services to the customer.

Rivalry

The MNE examines the rivalry that exists between itself and the competition and seeks to anticipate future changes in this arrangement. Common strategies for maintaining and/or increasing market strength include: (1) offering new goods and services; (2) increasing productivity and thus reducing overall costs; (3) working to differentiate current goods and services from those of the competition; (4) increasing overall quality of goods and services; and (5) targeting specific niches with a well-designed market strategy.

As the MNE examines each of these five forces, it must decide the attractiveness and unattractiveness of each. This will help decide how and where to make strategic changes. Figure 8.2 shows the five-forces model applied to the semiconductor industry.

Notice in Figure 8.2 that at the time this analysis was conducted, the suppliers in the semiconductor industry were not very powerful, so they were an attractive force for the MNE. Buyers did not have many substitute products from which to choose (an attractive development), but there was some backward integration towards purchasing their own sources of supply (an unattractive development). Overall, the attractiveness of buyer power was regarded as inconclusive. The third force, entry barriers, was quite attractive because of the high costs of getting into the industry and the short product life cycles that existed there. It was very difficult for a company to enter this market. The fourth force, substitutes, was unattractive because new products were being developed continually and customer loyalty was somewhat low. The fifth and final force, industry rivalry, was also unattractive because of the high cost of doing business, the cyclical nature of sales and the difficulty of differentiating one’s products from those of the competition.

On an overall basis, however, the industry was classified as attractive. It also appeared that the industry would see consolidation of smaller firms into

larger firms that would have greater resources to commit to research and development.

MNEs operating in the semiconductor industry would use this analysis to help them increase the attractiveness of those forces that currently are not highly attractive. For example, they could work to develop state-of-the-art semiconductors that might be substituted for the competition's products, and they would attempt to maintain a technological advantage so that the substitute force would not become a problem for them. In the process, they would likely be better able to increase their power over the buyers since their products would be so high-tech that the customers could not do better by purchasing from a competitor. In summary, environmental assessment, such as that provided by an analysis of competitive forces, is used to determine MNE opportunities and threats, and to help identify strategies for improving market position and profitability.

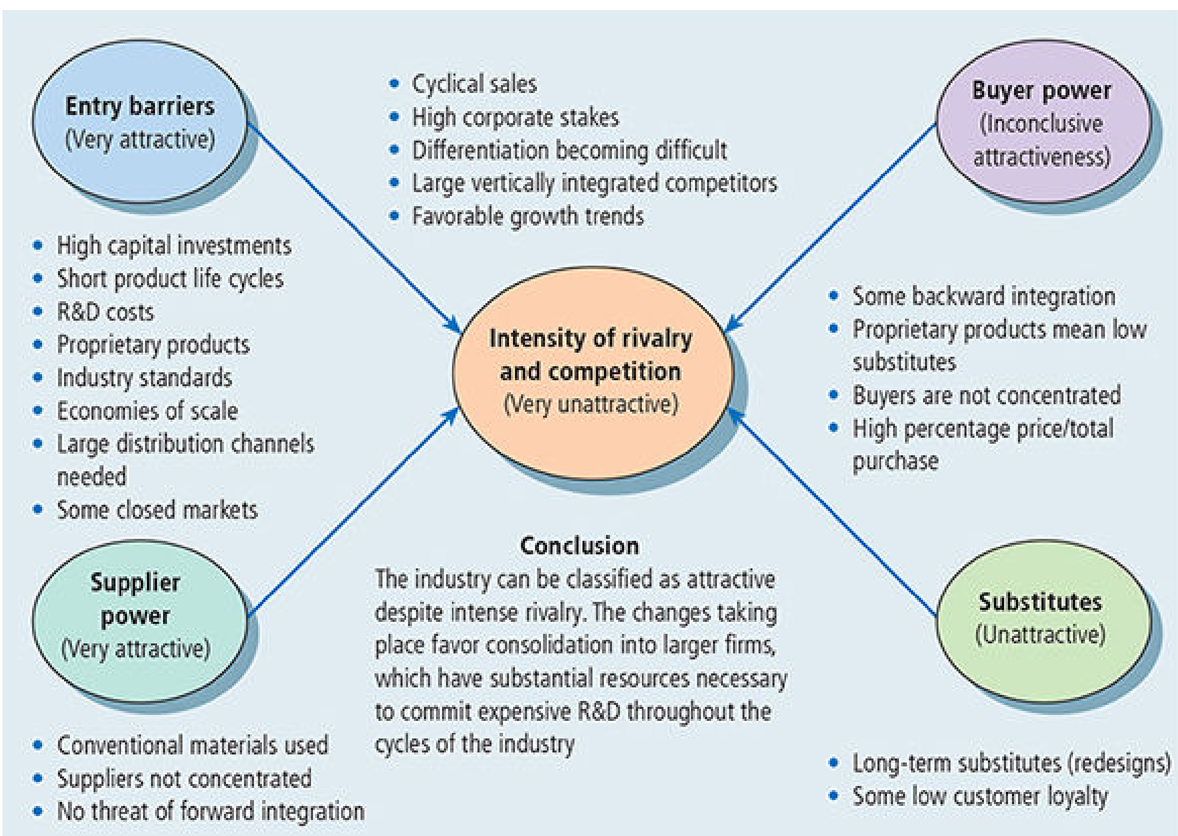

Figure 8.2 The five-forces model applied to the semiconductor industry

Source: Scott Beardsley and Kinji Sakagami, “Advanced micro devices: poised for chip greatness,” unpublished student paper, Sloan School of Management, MIT, 1988. Reported in Arnoldo C. Hax and Nicolas S. Majluf, *The Strategy Concept and Process: A Pragmatic Approach* (Englewood Cliffs, NJ: Prentice Hall, 1991), p. 46.

✔ Active learning check

Review your answer to Active Learning Case question 1 and make any changes you like. Then compare your answer to the one below.

1 Given the competitiveness of the environment, how much opportunity exists for Vodafone in the international cell phone market?

As seen from the case data, the international opportunities in this industry are great. One reason is because the market is going to continue growing and updating itself with new technology that may allow Vodafone to increase its revenue per subscriber and carve itself a larger portion of the market. The number of cell phone users in the United States has increased sharply in the recent past, following the trajectory of Europe. New technology will allow for expansion in all three triad markets. The key to success in this industry is to have a presence in all major markets. China is an important market because of its large population and high average usage of mobile services, but the market is highly competitive and customers favour local mobile companies. In 2010, Vodafone sold its 3.2 per cent stake of investment to the joint venture partner China Mobile. However, other emerging markets also represent opportunities for Vodafone. It has developed its presence in Singapore and Malaysia through joint ventures with local firms. Australia and New Zealand are also important target markets. Finally, adoption in African counties is also growing rapidly, partly on the back of financial services such as M-Pesa. M-Pesa ('M' is for mobile, Pesa is Swahili for money) is Vodafone's mobile money transfer service which avoids the need for banks. It began in 2007 in Kenya and has expanded across other parts of the continent and beyond. It points the way for Vodafone, not just in terms of future profitability, more of which will come from mobile services which add value to customers, but also in terms of the positive contribution the firm can make to supporting and enabling the poorest communities on the planet.

Internal environmental assessment

The internal environmental assessment helps pinpoint MNE strengths and weaknesses. There are two specific areas that a multinational should examine in this assessment: (1) physical resources and personnel competencies; and (2) the way in which value chain analysis can be used to bring these resources together in the most synergistic and profitable manner.

Physical resources and personnel competencies

The physical resources are the assets that the MNE will use to carry out its strategic plan. Many of these are reported on the balance sheet as reflected by cash, inventory, machinery and equipment accounts. However, this does not tell the whole story. The location and disposition of these resources is also important. For example, an MNE with manufacturing plants on three continents may be in a much better position to compete worldwide than a competitor whose plants are all located in one geographic area. Location affects cost, particularly for example in steel, heavy-weight manufacturing, engineering and automotive industries.

Another important consideration is the degree of integration that exists within the operating units of the MNE. Large companies, in particular, tend to be divided into **strategic business units (SBUs)**. These are operating units with their own strategic space that produce and sell goods and services to a market segment and have a well-defined set of competitors. SBUs are sometimes referred to as ‘businesses within the business’. Mitsubishi, the giant Japanese conglomerate, has a host of SBUs that constitute its corporate network, including steelmaking, auto production, electronics and banking. So when a Mitsubishi SBU that manufactures and sells consumer goods is looking for help with financing, it can turn to the banking SBU. If the bank finds that a customer needs a firm to produce a particular electronics product, it can refer the buyer to the electronics SBU.

In fact, some large MNEs use **vertical integration**, which is the ownership of all assets needed to produce the goods and services delivered to the customer. Many large Japanese manufacturing firms, in particular, have moved towards vertical integration by purchasing controlling interests in their suppliers. The objective is to obtain control over the supply and thus ensure that the materials or goods are delivered as needed. Many US and European firms have shied away from this strategy because 'captured suppliers' are often less cost effective than independents. A particular problem with vertical integration is defending oneself from competitors which are less vertically integrated and are able to achieve cost efficiencies as a result. The latter rely heavily on outsourcers and employ **virtual integration**, which is the ownership of the core technologies and manufacturing capabilities needed to produce outputs coupled with dependence on outsourcers to provide all other needed inputs. Virtual integration allows an MNE to operate as if it were vertically integrated, but it does not require the company to own all the factors of production, as is the case with vertically integrated firms.

Personnel competencies are the capabilities, knowledge and expertise of employees. The effectiveness with which a firm develops, deploys and manages its people is central to its success and often it only advantage against competitors. The structural organisation of the firm and its division of labour into functional divisions or SBUs, for example, is also an essential component of its competitive advantage. For example, if an MNE has an outstanding R&D department, it may be able to develop high-quality, state-of-the-art products. However, if the company has no sales arm, it will sell the output to a firm that can handle the marketing and distribution. Conversely, if a company lacks a strong R&D department but has an international sales force, it may allow the competition to bring out new products and to rely on its own R&D people to reverse-engineer them – that

is, to find out how they are built and develop technologies that can do the same thing – while relying on the sales force to build market share. Chapter 9 examines the structural and organisational ‘trade-offs’ for MNEs.

An understanding of what a company does well can help it decide whether the best strategy is to lead or to follow close behind and copy the leader. Not every MNE has the personnel competencies to be first in the field, and many are happy to follow because the investment risk is less and the opportunity for profit is often good.

Value chain analysis

A complementary approach to internal environment assessment is an examination of the firm’s value chain.[6] A **value chain** is the way in which primary and support activities are combined to provide goods and services and increase profit margins. Figure 8.3 provides the general schema of a value chain. The primary activities in this chain include: (1) inbound logistics, such as receiving, storing, materials handling, and warehouse activities; (2) operations, in which inputs are put into final product form by performing activities such as machining, assembling, testing and packaging; (3) outbound logistics, which involve distributing the finished product to the customer; (4) marketing and sales, which are used to encourage buyers to purchase the product; and (5) service for maintaining and enhancing the value of the product after the sale through activities such as repair, product adjustment, training and parts supply. The support activities in the value chain consist of: (1) the firm’s infrastructure, which is made up of the company’s general management, planning, finance, accounting, legal, government affairs and quality management areas; (2) human resource management, which is made up of the selection, placement, appraisal, promotion, training and development of the firm’s personnel; (3) technology in the form of knowledge, research and development, and procedures that

can result in improved goods and services; and (4) procurement, which involves the purchasing of raw materials, supplies and similar goods.

MNEs can use these primary and support activities to increase the value of the goods and services they provide. As such, they form a value chain. Any firm can apply this idea of a value chain. For example, Makita of Japan has become a leading competitor in power tools for professional users worldwide because it was the first to use new, less expensive materials for making tool parts and to produce in standardised models. The firm operates 11 production bases, two located in each of Japan and China, and one each in the United States, Brazil, Canada, Mexico, the United Kingdom, Germany and Romania. It sells products worldwide, with over 80 per cent of its sales outside its home country, Japan.

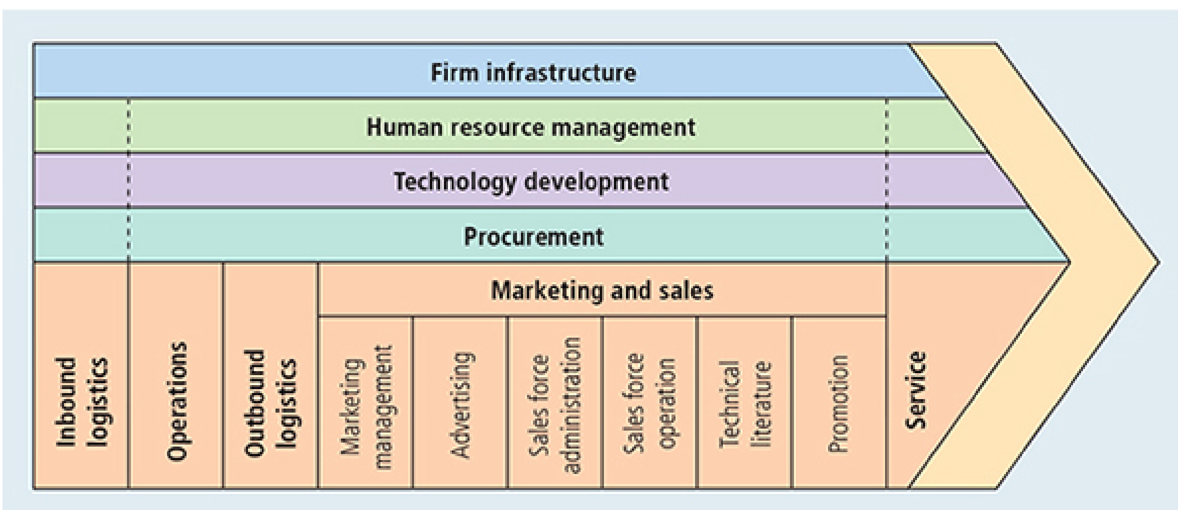

Figure 8.3 **A basic value chain**

Source: Adapted from The Free Press, an imprint of Simon & Schuster Adult Publishing Group, from *Competitive Advantage: Creating and Sustaining Superior Performance* by Michael E. Porter.

Analysis of value chains can also help a company determine the type of strategy that will be most effective. In all, there are three generic strategies: cost, differentiation and focus.

1. **Cost strategy** relies on such approaches as aggressive construction of efficient facilities, vigorous pursuit of cost reductions and overhead control, avoidance of marginal customer accounts, and cost minimisation in areas like R&D, service, sales and advertising.
2. **Differentiation strategy** is directed towards creating something that is perceived as being unique. Approaches to differentiation can take many forms, including the creation of design or brand image, improved technology or features, and increased customer service or dealer networks.
3. **Focus strategy** involves concentrating on a particular buyer group and segmenting that niche based on product line or geographic market.

While low-cost and differentiation strategies are aimed at achieving objectives industry-wide, a focus strategy is built around servicing a particular target market, and each functional policy is developed with this in mind.

In addition, the firm will determine its **competitive scope**, which is the breadth of its target market within the industry. Figure 8.4 provides an example of these generic strategies as applied to the worldwide shipbuilding industry.

The value chain can help an MNE create synergies within the organisation's activities. For example, by combining the human resource talent of their sales people with the expertise of their design and styling personnel, auto firms like Audi and Volkswagen have been able to increase their auto market share in western Europe in recent years, cutting costs while improving design and the financial services offer in sales divisions. Simply put, by analysing the ways of combining their primary and support activities, some automotive MNEs have been able to create a strategy that allows them to draw heavily on their strengths while minimising their weaknesses.

Active learning check

Review your answer to Active Learning Case question 2 and make any changes you like. Then compare your answer to the one below.

2 What type of generic strategy does Vodafone employ? Defend your answer.

Vodafone uses a focus strategy that is geared towards identifying market niches and meeting the needs of the mobile customers in these target groups. Notice that in the earlier phase of growth it was comfortable with acquisitions which left it with a minority shareholding (a 35 per cent stake in Verizon, for example). From 2014 onwards it wanted to be the major stakeholder, but also to have a partner which can help the company deal with the challenges in the local market. As the case notes, the company held over 50 per cent of the shares in most of the European countries in which it operates and sold its minority stake in Verizon in the United States in 2014. Another generic strategy has been to pay for its acquisitions through equity, which saved it from the technology crash of the early 2000s and subsequent financial challenges. So the company targets selected markets in which there is little risk and provides innovative products at competitive prices in order to compete effectively.

Competitive Scope		Competitive Advantage: Cost	Competitive Advantage: Differentiation
	Broad	Lower cost, volume production, wide range of models/options e.g. S. Korea	Higher cost, higher quality, wide range of models/options e.g. Japan
	Narrow	Low cost, lower quality, volume production, fewer models/options e.g. China	High cost, high quality, specialist and customised models/options e.g. Norway

Figure 8.4 Competitive strategies in global shipbuilding

Goal setting

External and internal environmental analyses provide an MNE with the information needed for setting goals. Some of these goals will be determined during the external analysis, as the company identifies opportunities it wants to exploit. Others will be finalised after the value chain analysis is complete. In either event, one of the outcomes of strategy formulation will be the identification of goals. Figures 1 and 2 in the opening section ‘Frameworks for this Book’ are useful roadmaps for our approaches to understanding MNE strategy and structure. Figure 2 links the key set of decisions made by MNE managers with a range of frameworks that we use to guide decision makers.

There are two basic ways of examining the goals or objectives of international business operations. One is to review them on the basis of operating performance or functional area. Table 8.2 provides an illustration. Some of the major goals are related to profitability, marketing, production, finance and human resources. A second way is to examine these goals by geographic area or on an SBU basis. For example, the European group may have a profitability goal of 16 per cent, the North American group’s profitability goal may be 17 per cent, and the Pacific Rim group may aim for 18 per cent. Then there are accompanying functional goals for marketing, production and finance. If the MNE has SBUs, each SBU in these geographic locales will have its own list of goals.

Table 8.2 Typical goals of an MNE

Profitability	Marketing	Production	Finance	Human resource management
Level of products	Total sales volume	Ratio of foreign to domestic production share	Financing of foreign affiliates – retained earnings or local borrowing	Development of managers with global orientation
Return on assets, investment, equity, sales	Market share – worldwide, region, country	Economies of scale via international production integration	Taxation – minimising the burden globally	Management development of host-country nationals
Annual profit growth	Growth in sales volume	Quality and cost control	Optimum capital structure	
Annual earnings per share growth	Integration of country markets for marketing efficiency and effectiveness	Introduction of cost-efficient production methods	Foreign exchange management – minimising losses from foreign fluctuations	

Source: Adapted from *International Dimensions of Management*, 2nd ed., by A. Phatak © 1989 South-Western, a part of Cengage. Reprinted by permission www.cengage.com/permissions/.

This approach uses what is called a 'cascading effect' – like a cascade of water rippling down the side of a hill, it reaches the bottom by moving from one level to the next. The MNE starts out by setting a profitability goal for the overall enterprise. Each geographic area or business unit is then assigned a profitability goal that, if attained, will result in the MNE reaching its overall desired profitability. The same approach is used in other key areas such as marketing, production and finance. Within each unit, these objectives are further subdivided so that every part of the organisation understands its objectives and everyone is working towards the same overall goals.

STRATEGY IMPLEMENTATION

Strategy implementation is the process of attaining goals by using the organisation structure to execute the formulated strategy properly. There are many areas of focus in this process. Three of the most important are location, ownership decisions and functional area implementation. The case **International Business Strategy in Action: Fuji Xerox and Xerox** illustrates how these considerations can be used in gaining market entry.

Location

Location is important for a number of reasons. Local facilities often provide a cost advantage to the producer, particularly when the raw materials, parts or labour needed to make the product can be inexpensively obtained close to the facility. Location is also important because residents may prefer locally produced goods. For example, many people in the United States like to 'buy American'. Some locations may also be attractive because the local government is encouraging investment through various means such as low tax rates, free land, subsidised energy and transportation rates, and low-interest loans while subjecting imported goods to tariffs, quotas or other governmental restrictions, thereby making local manufacture more desirable. Finally, the MNE may already be doing so much business in a country that the local government will insist that it set up local operations and begin producing more of its goods there. This is a major reason why Japanese auto manufacturers began to establish operations in the United States.

INTERNATIONAL BUSINESS STRATEGY IN ACTION

Fuji Xerox and Xerox

Fuji Xerox was created in 1962 as a 50/50 joint venture between UK-based Rank Xerox and Fujifilm Holdings Corporation. It is regarded as the most successful partnership between US and Japanese firms. The arrangement developed from a sales operation for Xerox products in Japan into a fully integrated organisation with its own R&D and manufacturing. By 1990, Fuji Xerox revenues were $4 billion and the company had a world product mandate to supply the entire Xerox Group with the low- to mid-range copiers that were the core of its business. Indeed, as Xerox's monopoly on large copiers began to dwindle in the 1970s, it was its Japanese partner, Fuji Xerox, that rode to the rescue with its new, high-quality smaller copiers.

In 1975, Xerox was forced by the US Federal Trade Commission to license its original core copier technology to rivals such as IBM, Kodak, Ricoh and Canon. If it had not been for Fuji Xerox developing new copier technology, Xerox would have failed. The firm's early monopoly in the world copier business was eroded sharply by intense rivalry from Japanese competitors such as Canon and Ricoh as well as from Kodak and IBM. These rivals produced higher-quality, lower-priced, more technologically advanced, and more reliable copiers than Xerox.

When Fuji Xerox recognised the threat, its managers, acting autonomously, started R&D into new small copiers. The US head office was slow to take on board the technology and products of its Japanese partner. Loss of market share, however, especially to Canon, eventually led to ever-closer degrees of cooperation between Xerox and Fuji Xerox. In particular, the high quality standards of Fuji Xerox were spread throughout the Xerox Group, and its total quality management (TQM) techniques helped Xerox regain market. In this context, Xerox was helped by a partner that was the hotbed of TQM and copier innovation in the 1970s and 1980s.

One of the reasons for success in the collaboration between Xerox and Fuji Photo Films was that the latter acted as a silent partner in the 50/50 joint venture and allowed Fuji Xerox to develop its own management cadre, who became skilled in R&D and copier technology and in the manufacturing and marketing of small copiers. Fuji Xerox also transformed itself from a marketing

subsidiary into a full-line business, thus ending up being more innovative and responsive to the market than Xerox itself.

In 2009, Fuji Xerox had revenues totalling US$11.080 billion with 40,646 employees. For its part, in 2014 Xerox's revenues totalled $19,540 million with over 100,000 employees. For the year ended 31 March 2014, Fujifilm Holdings Corporation reported revenue of US$20.23 billion (¥2,440.0 billion) and 78,595 employees. Fuji Xerox recorded the same level of revenues in 2018 and a slightly higher figure of 44,596 employees. Fujifilm had marginally increased both, to $21 billion revenues and 79,000 employees in 2018.

However, the joint venture between Xerox and Fuji was at breaking point in 2018 as the two global companies failed to complete a long-agreed full merger. Initially, Xerox and Fujifilm had agreed to a merger in January 2018, however, the corporate board at Xerox decided to put a halt on the merger after legal action by billionaire activist investors Carl Icahn and Darwin Deason, who stated that deal undervalued the company. Inevitably, the dispute resulted in a lawsuit. Fujifilm sued the American firm for over $1 billion on the grounds of terminating an agreement. At this point, Xerox were not producing office copiers independently of the Fuji Xerox joint venture, which was 75 per cent owned by Fujifilm and just 25 per cent owned by Xerox. This substantial difference in ownership and power makes Xerox the weaker partner, raising serious questions about its corporate strategy.

Websites: www.fujixerox.co.jp; www.xerox.com; www.fujifilm.com;
https://money.cnn.com/2018/05/14/investing/xerox-fujifilm-deal-off/index.html

Sources: Adapted from Benjamin Gomes-Casseres and Krista McQuade, *Xerox and Fuji Xerox*, Harvard Business School Case 9–391–156; David T. Kearns and David A. Nadler, *Prophets in the Dark: How Xerox Reinvented Itself and Beat Back the Japanese* (New York: Macmillan, 1992); Benjamin Gomes-Casseres, 'Group Versus Group: How Alliance Networks Compete', *Harvard Business Review* (July/August 1994), pp. 62–74; www.hoovers.com; FujiFilm Holdings Corporation, *Annual Report*, 2010, 2014; Xerox, *Annual Report*, 2009, 2014; Jethro Mullen, Xerox pulls out of Fujifilm merger and teams up with Carl Icahn, 2018, CNN Business.

Although the benefits can be great, a number of drawbacks are associated with locating operations overseas. One is an unstable political climate that can leave an MNE vulnerable to low profits and bureaucratic red tape. Chapter 14 details different forms of political risk, from a change in import duties to the possibility of revolution or armed conflict, and explains how firms can measure, mitigate against and monitor them as they evolve.

Ownership

Ownership of international operations has become an important issue in recent years. Many Americans, for example, believe that the increase in foreign-owned businesses in the United States is weakening the economy. People in other countries have similar feelings about US businesses there. In truth, the real issue of ownership is whether or not the company is contributing to the overall economic good of the country where it is doing business. Countries that want to remain economically strong must be able to attract international investors who will provide jobs that allow their workers to increase their skills and build products that are demanded on the world market. But ownership can be partial; firms can expand into overseas markets via alliances and joint ventures, through shared-ownership with local firms.

Strategic alliances

Sometimes companies prefer to invest in another country and maintain 100 per cent ownership. This, however, is often very expensive and risky. Given that the MNE may not have much experience in that particular marketplace, local partners may be very helpful in dealing with all sorts of local barriers. As a result, it is becoming increasingly popular to find MNEs turning to the use of strategic partnerships. A strategic alliance or partnership is an agreement between two or more competitive MNEs for the purpose of

cooperating in some manner in serving a global market.[7] The type of cooperation can be in marketing, research or a more comprehensive manner. In recent years these partnerships have become increasingly popular, although careful management of such agreements continues to be a critical area of concern.

International joint ventures

An **international joint venture (IJV)** is an agreement between two or more partners to own and control an overseas business. This is a special type of a strategic alliance that involves setting up a new business entity, generally involving management separate from that of the partners' own management teams. IJVs take a number of different forms[8] and offer a range of opportunities. One of these reasons is government encouragement and legislation designed to make it attractive for foreign investors to bring in local partners. A second reason is the growing need for partners which know the local economy, the culture and the political system and which can cut through red tape in getting things done – something IJVs often do very well. This is a key stage in the Uppsala model of internationalisation described in Chapter 2. Indeed, IJVs are often the result of two or more companies identifying the potential for 'synergies', wherein each partner brings to the venture what the other partner needs but is lacking in. For example, an MNE might provide a local partner with technology know-how and an infusion of capital that, in turn, will allow the local firm to expand operations, raise market share and begin exporting.

Unfortunately, in many cases IJVs have not worked out well. Several studies found a failure rate of 30 per cent for ventures in developed countries and 45–50 per cent in less developed countries.[9] The major reason has been the desire by foreign MNEs to control local operation, which sometimes has

resulted in poor decision making and/or conflicts with the local partners. In general, joint ventures are difficult to manage and are frequently unstable.[10]

Active learning check

Review your answer to Active Learning Case question 3 and make any changes you like. Then compare your answer to the one below.

3 What form of ownership arrangement is Vodafone using to gain world market share? Explain.

Vodafone uses two basic approaches, but it is important to note that its strategy regarding ownership has changed a number of times during its growth. The most common approach is the international joint venture, which is seen by the company's decisions to acquire an ownership position in a local company but have a local partner hold the remainder of the ownership. Its minority stake in Verizon Wireless, which became the largest US mobile telephone operator in America, illustrates this. In some cases, however, Vodafone opts for total ownership and purchases the entire company, usually when it believes it does not need a local partner. An example is AirTouch Communications, where Vodafone acquired the entire firm. In both cases, of course, the ownership arrangement is designed to help Vodafone continue to increase its market share in that geographic region.

Functional strategies

Functional strategies are used to coordinate operations and ensure that the plan is carried out properly. The specific functions that are key to the success of the MNE will vary, but they typically fall into the following areas: marketing, services, manufacturing, finance, procurement, technology and human resources. For purposes of analysis, they can be simplified into three major considerations: marketing, production and finance.

Marketing

The marketing strategy is designed to identify consumer needs and formulate a plan of action for selling the desired goods and services to these customers. Most marketing strategies are built around what are commonly known as the 'four Ps' of marketing: product, price, promotion and place. The company identifies the products that are in demand in the market niches it is pursuing. It apprises the production department of any modifications required to meet local needs, and it determines the price at which the goods can be sold. Then the company devotes its attention to promoting the products and services and selling them in the local market.

Production

Designed to fit together with the marketing plan, the production strategy ensures that the right products and services are developed and delivered in time for sale. Production also coordinates its strategy with the procurement and technology people to ensure that the desired materials are available and the products have the necessary state-of-the-art quality. If the MNE is producing goods in more than one country, it gives attention to coordinating activities where needed. For example, some firms manufacture goods in two or more countries, then assemble and sell them in other geographic regions. Japanese auto firms send car parts to the United States for assembly and then sell some of the assembled cars in Canada, Mexico and South America. Whirlpool builds appliances worldwide with operations in Brazil, Canada, Mexico, the Netherlands and seven other countries. Such production and assembly operations have to be coordinated carefully.

Finance

Financial strategy often serves to both lead and lag the other functional strategies. In the lead position, finance limits the amounts of money that can be spent on marketing (new product development, advertising, promotion)

and manufacturing (machinery, equipment, quality control) to ensure that the desired return on investment is achieved. In the lag position, the financial strategy is used to evaluate performance and provide insights into how future strategy should be changed.

Financial strategies used to be formulated and controlled out of the home office. In recent years, however, MNEs have learned that this approach can be cumbersome and, due to fluctuating currency prices, costly as well. Today's overseas units have more control over their finances than before, but they are guided by a carefully constructed budget that is in accord with the overall strategic plan. They are also held to account for financial performance in the form of return on investment, profit, capital budgeting, debt financing and working capital management.

CONTROL AND EVALUATION

The strategy formulation and implementation processes are subject to control and evaluation. This process involves examining the MNE's performance to determine (1) how well the organisation has done and (2) what actions should be taken in light of this performance. This process is tied directly to the overall strategy in that the objectives serve as the basis for comparison and evaluation. Figure 8.5 illustrates how this process works.

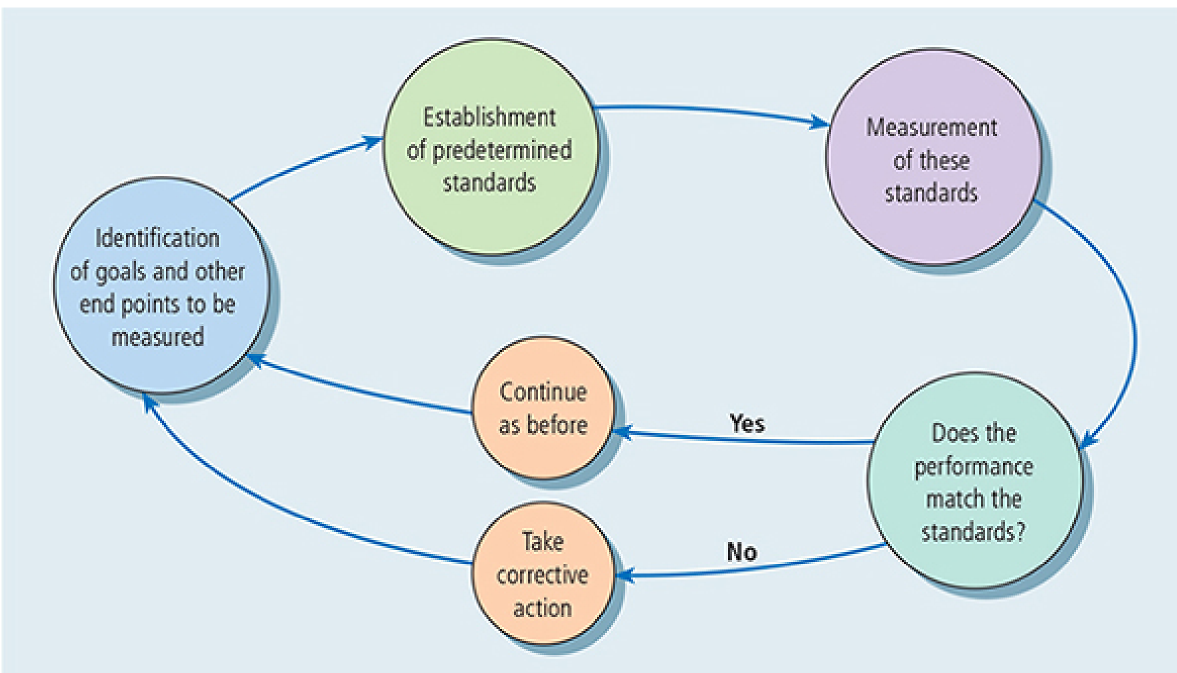

Figure 8.5 The control and evaluation process

If the comparison and evaluation show that the SBU or overseas operation is performing according to expectations, then things will continue as before. The objectives may be altered because of changes in the strategic plan, but otherwise nothing major is likely to be done. On the other hand, if there have been problems, the MNE will want to identify the causes and

work to eliminate or minimise them.[11] Similarly, if the unit has performed extremely well and achieved more than forecasted, management may want to reset the objectives to a higher level because there is obviously greater market demand than was believed initially. In making these decisions, the company uses a variety of measures. Some are highly quantitative and depend on financial and productivity performance; others are more qualitative and judgmental in nature. The following discussion examines six of the most common methods of measurement used for control and evaluation purposes.

Common methods of performance measurement

Specific measures will vary depending on the nature of the MNE and the goals it has established. However, **return on investment (ROI)**, which is measured by dividing net income before taxes by the costs of investment, is a major consideration in most cases. There are a number of reasons why ROI is so popular as a control and evaluation measure: (1) it is a single comprehensive result that is influenced by everything that happens in the business; (2) it measures how well the managers in every part of the world are using the investments at their command; and (3) it allows a comparison of results among units in the same country as well as on an intercountry basis. Of course, there are shortcomings as well: (1) if one unit is selling goods to another unit, the ROI of the former is being artificially inflated; (2) the ROI in a growing market will be higher than that in markets that are just getting off the ground or are maturing, so that a comparison of the ROI performance between units can be misleading; and (3) the ROI is a short-term measure of performance that, if relied on too heavily, will not help managers develop the necessary long-term time horizons. Despite these shortcomings, however, ROI remains a major measure of performance.

Another measure is sales growth and/or market share. Units are given sales targets that usually require greater sales this year than last year. If the firm has made an estimate of the total demand, a market share figure accompanies the sales target for two reasons: (1) the MNE wants to increase its sales; and (2) the firm at least wants to maintain, if not increase, market share. If the market is judged to be declining, sales targets are lowered but the MNE still tries to maintain market share.

Costs and cost control measures are also common. The MNE wants to achieve increased sales and market share at as low a cost as possible. It also wants to maintain close control of production costs. So expenses are monitored carefully. This is particularly important in declining markets, where the company will want to cut costs as sales decline. For example, if an MNE estimates that it has only three years of product life in the market, it is likely that much of the advertising and promotion expenses will be dropped as the company focuses attention on supplying an ever-decreasing number of customers. This strategy is often successful because the remaining customers are highly loyal and do not need promotional efforts to convince them to buy the product.

New product or service development and/or rate of innovation are other relevant performance measures. This area is extremely important for firms that rely on new offerings. In fast-moving markets, like fashion, luxury consumer products, online gaming and technology gadgets, product improvement or innovation is critical to success and new product development is a key area for control and evaluation. Rate of new launches, percentage of product/service portfolio, market share or profits/rate of return derived from new products or services (e.g. launched in past three years) are common measures of innovation success.

Firms also measure their performance in terms of **Corporate Social Responsibility (CSR), ethics and sustainability**. Triple Bottom Line

(TBL), for example is an accounting framework which includes social and environmental (or ecological) accountability measures alongside financial. Some organisations have adopted this approach to evaluate their performance to create greater business value. The three pillars are also referred to as: people, planet and profits. The **Real Case: 3M** below provides a good illustration of how one firm incorporates sustainability goals into its everyday performance evaluation.

Finally, management performance, which underpins the achievement of the aggregate firm-level performance, needs to be considered. Most firms monitor and evaluate management through both quantitative and qualitative measures, linked to personal development reviews. In the quantitative area, in addition to those discussed above, other common considerations include return on invested capital and cash flow. In the qualitative area, in addition to host-country relations, consideration is given to relations with the home office, the leadership qualities of the unit's managers, how well the unit is building a management team, and how well the managers of the unit have implemented the assigned strategy.

These methods of measurement are used in arriving at an overall assessment of the unit's performance. Based on the results, the MNE can then set new goals and the international strategic planning process begins anew.

Active learning check

Review your answer to Active Learning Case question 4 and make any changes you like. Then compare your answer to the one below.

4 On what basis would a firm like Vodafone evaluate performance? Identify and describe two.

Vodafone uses a number of bases on which to evaluate performance. One is market share. Note that the firm keeps track of how many subscribers it has by multiplying its ownership position in a venture by the venture's total subscription base. Another is overall worldwide market share. Finally, the firm evaluates its performance by its success in setting a footprint in all major markets.

KEY POINTS

1. Strategic planning is the process of determining an organisation's basic mission and long-term objectives, then implementing a plan of action for attaining these goals. In carrying out their strategic plan, most MNEs tend towards one of four specific predispositions: ethnocentric, polycentric, regiocentric and geocentric. Each was described in the chapter.
2. The international strategic planning process involves three major steps: strategy formulation, strategy implementation and the control and evaluation of the process.
3. Strategy formulation entails the evaluation of the enterprise's environment and the identification of long-range and short-range objectives. The five forces that determine industry competitiveness is often used to frame this process: buyers; suppliers; new entrants to the industry; the availability of substitute goods and services; and rivalry among the competitors.
4. The analysis of the internal environment involves consideration of the firm's assets, capabilities and expertise and the ways in which these are organised to respond to external threats and opportunities. Value chain analysis (internal and external) can be helpful to guide organisation, coordination and focus on strategic priorities.
5. Strategy implementation is the process of attaining predetermined goals by properly executing the formulated strategy. Three of the most important areas of consideration are location, ownership decisions and functional area implementation.

6 The control and evaluation process involves an examination of the MNE’s performance to determine how well it has done and to decide what action now needs to be taken. Some of the most common measures include return on investment, sales growth, market share, costs, new product development, Corporate Social Responsibility (CSR), ethics and sustainability, and overall management performance.

Key terms

- **strategic planning**
- **ethnocentric predisposition**
- **polycentric predisposition**
- **regiocentric predisposition**
- **geocentric predisposition**
- **strategy formulation**
- **competitive intelligence**
- **strategic business units (SBUs)**
- **vertical integration**
- **virtual integration**
- **value chain**
- **cost strategy**
- **differentiation strategy**
- **focus strategy**
- **competitive scope**

- **strategy implementation**
- **international joint venture (IJV)**
- **return on investment (ROI)**
- **Corporate Social Responsibility (CSR)**

REVIEW AND DISCUSSION QUESTIONS

1. Define the term *strategic planning*.
2. In what way can the following basic predispositions affect an MNE's strategic planning: ethnocentric, polycentric, regiocentric, geocentric?
3. How will an MNE carry out an external environmental assessment? Identify and describe the two major steps involved in this process.
4. Of what practical value is an understanding of the five-forces model presented in Figure 8.1. How would an MNE use this information in the strategic planning process?
5. In conducting an internal environmental assessment, why would an MNE want to identify its physical resources and personnel competencies?
6. What is a value chain? How can this chain be used in an internal environmental assessment?
7. What are the three generic strategies? When would an MNE use each? Support your answer with examples.
8. What are some typical MNE goals? Identify and briefly describe four major types.
9. One of the most important considerations when implementing a strategy is that of location. What does this statement mean?
10. When are MNEs likely to use an international joint venture? When would they opt for a strategic partnership? Defend your answer.
11. Functional strategies are used to coordinate operations and ensure that the plan is carried out properly. What are some of the most common types of functional strategies? Identify and describe three.
12. How do MNEs control and evaluate their operations? Describe the basic process. Then discuss some of the common methods of measurement.

REAL CASE

3M

3M is a major MNE with over 55,000 products sold in 200 countries, comprising everything from office supplies to construction and building maintenance to chemicals. In 2017, it employed over 90,000 people, had operations in more than 70 countries and generated $31.7 billion in revenue. Taking this into account, one may question: how does the firm manage such a large international operation? One way is by adapting its global strategies to the needs of local markets.

The company balances its global strategies and national responses on a region-by-region basis. For example, in Europe the company has set up a series of business centres to address local differences. The company also uses European management action teams (EMATs) to balance the needs of subsidiaries in responding to local expectations with the corporation's need for global direction. Today, 3M has 50 EMATs in Europe, each consisting of from 8 to 14 people, most of whom are marketing personnel. These groups are charged with bringing the firm's global plans to life by helping their execution at the local level. EMAT meetings, which usually occur quarterly, are designed to create action plans for the European subsidiaries. When the meetings are over, the members then return to their respective subsidiaries and begin executing the plans. In Asia the company uses a different approach, relying heavily on its Japanese operation to provide much of the needed direction to the subsidiaries. At the same time, there are regional centres in Singapore and South Korea that help subsidiaries to address their local markets. In Latin America, meanwhile, 3M uses a macro approach, conducting business on a national rather than regional basis.

3M is seen by some as one of the first global manufacturing firms to integrate environmental sustainability into its global strategy, across all its operations, despite the obvious organisational complexity outlined above. It was among the first group of firms to be listed on the Dow Jones Sustainability Index when it started in 1999. In 2014 it won the US Environmental Protection Agency's (EPA) ENERGY STAR® award for the tenth year in a row for its worldwide energy-conservation efforts. These awards, alongside a range of indicators which the firm uses to measure

its progress as a responsible company, suggest that it is genuinely concerned about its wider stakeholders. These examples come from its *Annual Sustainability Report* (2015):

- 3M's Pollution Prevention Pays programme has prevented nearly 2 million tons of air, water and waste pollution, and the reduction of the company's global greenhouse gas emissions by 57 per cent from 2002 to 2013 on an absolute basis (even as the company sales grew 30 per cent over the same period of time).
- Ongoing support to protect and restore vital ecosystems around the world. By working with partners such as The Nature Conservancy, the 3M Foundation has provided more than $21 million to preserve more than 1 million acres.
- More than $61.6 million in global cash and in-kind product donations in 2013.
- In 2014 3M joined the United Nations Global Compact, formalising its commitment to the ten principles of the Compact in the areas of human rights, labour, the environment and anti-corruption.

In 2015, 3M also asserted that they had set a sustainability 10-year goal cycle. Some of the 2025 sustainability goals are as follows:

- reduce manufacturing waste by an additional 10 per cent, indexed to sales;
- achieve 'zero landfill' status at more than 30 per cent of manufacturing sites;
- reduce global water use by an additional 10 per cent, indexed to sales;
- improve energy efficiency indexed to net sales by 30 per cent;
- increase renewable energy to 25 per cent of total electricity use;
- provide training to 5 million people globally on worker and patient safety;
- invest cash and products for education, community and environmental programmes; and
- 100 per cent participation in employee development programmes to advance individual and organisational capabilities.

Some firms develop sophisticated vision and mission statements or advertising campaigns to promote their ethical or environmental credentials. It is always worth looking at the evidence and in 3M's case the rhetoric does seem to be matched by the numbers.

Website: www.3m.com

Sources: Adapted from Harry Mammerly, 'Matching global strategies with national responses', *Journal of Business Strategy* (March/April 1992), pp. 8–13; www.3m.com; 3M, *Annual Report*, 2009–17; 3M *Sustainability Report* (2015–2018) at: http://www.3m.com/3M/en_US/sustainability-us/.

1 Discuss how 3M balances its global strategy in Europe and Asia.

2 Does 3M include environmental sustainability into its global strategy?

REAL CASE

Social media: Serengetee

Source: https://www.serengetee.com/men-women/mission/

Social media can have a significant impact on the success of a business as online communication can overcome traditional obstacles by transforming physical proximity with virtual interaction. Given the rise in the use of smartphones, social media is a vital tool for businesses, as it enables them to listen to and learn from their customers, as well as connect with other stakeholders. Social media represents a suite of new communications, market research and 'market shaping' tools for businesses.

Although major corporations such as Starbucks, Virgin, Adidas and Levi's have been using social media to their advantage for quite some time, it is important to acknowledge that small businesses are also utilising this tool. Given that small firms often find it more difficult than larger firms to acquire traditional resources and lack the financial power, and global scale and scope of

big multinationals, social media probably offers a more significant range of opportunities for small firms. For instance, websites such as Twitter and Facebook can provide small businesses with a platform to reach out to new customers, without requiring investment in marketing and IT.

Young entrepreneurs are utilising social media to assist their businesses, and a good example of this is Serengetee, a firm that has acquired a niche position within the t-shirt market. Jeff Steitz and Ryan Westberg, who are the co-founders of Serengetee, came up with their business as they were sailing in a boat around the world with Semester at Sea. Semester at Sea comprised of an academic programme in which students have their academic classes taught on a boat, while visiting and learning from different countries around the world. On this journey, Steits and Westerberg decided to collect fabrics from countries in Africa, Asia and Central America and came up with a novel idea of producing colourful pockets on t-shirts, where each of the pockets were made from the fabrics they had collected from different countries. When forming their business in 2012, they also decided that a core principle would be to help the communities from which they sourced their material. They initially did this by donating 5 per cent of their profits to the local needs of these countries.

As Serengetee's business model was based on acquiring and sourcing fabrics from all over the world, the two entrepreneurs needed a way to stay connected to both their customers and suppliers. As such, they decided to utilise social networks, which included Twitter, Facebook, Pinterest and Instagram, for this purpose. Steits and Westerberg also used Hootsuite to plan and schedule their social media activities weeks in advance. This helped them to build their brand even when they couldn't guarantee access to the internet. Furthermore, by adopting the clever hashtag #WeartheWorld, the two entrepreneurs were able to monitor conversations, especially those concerning new products, via their Hootsuite dashboard.

The social media strategy quickly flourished as in Serengetee's first operational year the firm acquired 20,000 Facebook fans, which increased to over 100,000 fans in year two. As of 2018, Serengetee has acquired over 400,000 followers on Facebook, 144,000 followers on Instagram and over 25,000 followers on Twitter. Furthermore, Serengetee uses social media as a tool to make their consumers aware of their CSR initiatives that support their mission, which was built on the

notion of ‘giving back to communities’; the company now gives back 10 per cent of their profits to these communities.

Overall, since 2012, Serengetee has managed to donate well over $60,000 to 32 causes in 28 countries across the world. The firm today still acknowledges the importance of social media and recruits company representatives from their customer base, with ‘being active on social media’ specified as a key requirement for the role. Another way in which Serengetee uses social media to connect with their consumers is by organising a ‘Fan of The Week’ initiative on their website. This involves consumers posting a picture of themselves while wearing one of Serengetee’s products accompanied by the hashtag #FOTW. The picture that receives the greatest number of likes on the Serengetee page has a chance to win $100 store credit.

Serengetee is just one example showing how small businesses are using the internet and social media to achieve strategic objectives. It is reported that approximately 75 per cent of small businesses use social media. In terms of ranking these social platforms, Facebook is found to be used the most, followed by YouTube, Twitter and LinkedIn. Importantly, although LinkedIn is used the least in small business, LinkedIn has been favoured by small businesses as the social media platform that provides these firms with the greatest value, followed by Facebook.

The internet and social media has undoubtedly changed the way in which businesses disseminate information and communicate with their customers. Although small businesses may not possess the same resources as larger firms, they can use social media at little cost. But there are additional advantages from using social media technologies, platforms and services, product promotion. Firms can recruit employees, communicate with wider stakeholders, strengthen their market research capabilities and actively shape consumer perceptions by informing them about the people and communities that support their global supply chains. When used correctly, the social benefits – as well as the economic and business benefits – of social media are significant.

Websites: https://techcrunch.com/2010/07/17/how-social-media-drives-new-business-six-case-studies/; https://twitter.com/serengetee?lang=en; https://www.serengetee.com

Source: Jones, N., Borgman, R. and Ulusoy, E. (2015) ‘Impact of social media on small businesses’, *Journal of Small Business and Enterprise Development*, vol. 22, no. 4, 611–32;

Maltby, E. and Ovide, S. (2013) 'Small firms say LinkedIn works, Twitter doesn't', *Wall Street Journal*, 31.

1 Is Serengetee a multinational enterprise?

2 What are Serengetee's firm-specific advantages?

3 Discuss how Serengetee communicates with its stakeholders.

NOTES

1 Tim Burt, ‘GM outlines plans to cut European capacity’, *Financial Times*, 27 September 2001, p. 19; Jorn Madslien, ‘General Motors gets ready to fix European subsidiaries’, *BBC News*, 3 March2011, http://www.bbc.co.uk/news/business-12625841

2 Also see Roland Calori, Leif Melin, Tugrul Atamer and Peter Gustavsson, ‘Innovative international strategies’, *Journal of World Business*, vol. 35, no. 4 (winter 2000), pp. 333–54; Kalevi Kyl-heiko, Ari Jantunen, Kaisu Puumalainen, Sami Saarenketo and Anni Tuppura, ‘Innovation and internationalization as growth strategies: the role of technological capabilities and appropriability’, *International Business Review* (2010).

3 M. A. Hitt, ‘The meaning of organizational effectiveness: multiple domains and constituencies’, *Management International Review*, vol. 28, no. 2 (1988), p. 28.

4 For more on this, see Michael Porter, *The Competitive Advantage of Nations* (New York: Free Press, 1990), chapter 2.

5 Andrew Pollack, ‘Nissan plans to buy more American parts’, *New York Times*, 26 March 1994, pp. 17, 26; ‘Vauxhall boss warns over UK car making future’, *BBC News*, 24 April 2011, http://www.bbc.co.uk/news/business-13179589

6 C. K. Prahalad and Kenneth Lieberthal, ‘The end of corporate imperialism’, *Harvard Business Review* (July/August 1998), pp. 69–79.

7 Peter Lorange, Johan Roos and Peggy Simcic Bronn, ‘Building successful strategic alliances’, *Long Range Planning* (December 1992), pp. 10–17; Inkpen, Andrew C., ‘Strategic alliances’, in Alan M.

Rugman (ed.), *The Oxford Handbook of International Business*, 2nd ed. (Oxford: Oxford University Press, 2009).

8 Hemant Merchant, ‘Configurations of international joint ventures’, *Management International Review*, vol. 40, no. 2 (2000), pp. 107–40.

9 Stefan H. Robock and Kenneth Simmonds, *International Business and Multinational Enterprises*, 4th ed. (Homewood, IL: Irwin, 1989), p. 216.

10 See Sing Keow Hoon-Halbauer, ‘Managing relationships within Sino-foreign joint ventures’, *Journal of World Business*, vol. 34, no. 4 (winter 1999), pp. 344–70.

11 Also see John Child and Yanni Yan, ‘Investment and control in international joint ventures: the case of China’, *Journal of World Business*, vol. 34, no. 1 (spring 1999), pp. 3–15; John Child, ‘China and international business’, in Alan M. Rugman (ed.), *The Oxford Handbook of International Business*, 2nd ed. (Oxford: Oxford University Press, 2009).

BIBLIOGRAPHY

Asmussen, Christian G. ‘Local, regional, or global? Quantifying MNE geographic scope’, *Journal of International Business Studies*, vol. 40 (September 2009). Banalieva, Elitsa R., and Athanassiou, Nicholas. ‘Regional and global alliance network structures of triad multinational enterprises’, *Multinational Business Review*, vol. 18, no. 1 (2010).

Augier, Mie and Teece, David J. ‘Dynamic capabilities and multinational enterprise: Penrosean insights and omissions’, *Management International Review*, vol. 47, no. 2 (2007).

Barney, Jay. *Gaining and Sustaining Competitive Advantage*, 3rd ed. (Upper Saddle River, NJ: Prentice Hall, 2007).

Buckley, Peter J. and Casson, Mark. ‘Edith Penrose’s theory of the growth of the firms and the strategic management of the multinational enterprise’, *Management International Review*, vol. 47, no. 2 (2007).

Collinson, S. and Liu, Y. ‘Recombination for innovation: performance outcomes from international partnerships in China’, *R&D Management*, vol. 49, no. 1, pp. 46–63 (2017).

Cravino, Javier and Levchenko, Andre A. ‘Multinational firms and international business cycle transmission’, *The Quarterly Journal of Economics*, vol. 132, no. 2 (2017).

Davis, Peter S., Desai, Ashay B. and Francis, John D. ‘Mode of international entry: an isomorphism perspective’, *Journal of International Business Studies*, vol. 31, no. 2 (summer 2000).

Demirbag, Mehmet, Tatoglu, Ekrem and Glaister, Keith W. ‘Institutional and transaction cost influences on partnership structure of foreign

affiliates', *Management International Review*, vol. 50, no. 6 (December 2010).

Egelhoff, William G. 'Great strategy or great strategy implementation: two ways of competing in global markets', *Sloan Management Review*, vol. 34, no. 2 (winter 1993).

Elg, U., Ghauri, P., Child, J. and Collinson, S.C. 'MNE Microfoundations and Routines for Building a Legitimate and Sustainable Position in Emerging Markets', *Journal of Organizational Behavior*, 38: 9, 1–18 (2017).

Ghemawat, Pankaj. *Redefining Global Strategy: Crossing Borders in a World Where Differences Still Matter* (Boston, MA: Harvard University Press, 2007).

Grant, Robert M. *Contemporary Strategy Analysis* (Oxford: Wiley-Blackwell, 2008).

Hamel, Gary and Prahalad, C. K. 'Do you really have a global strategy?' *Harvard Business Review*, vol. 65, no. 4 (July/August 1985).

Hashai, Niron, Asmussen, Christian G., Benito, Gabriel R. G. and Petersen, Bent. 'Technological knowledge intensity and entry mode diversity', *Management International Review*, vol. 50, no. 6 (December 2010).

Heracleous, L. and Collinson, Simon C. 'HSBC's strategy and leadership.' In K. Singh, N. Panagarkar and L. Heracleous (eds.), *Business Strategy in Asia*, 3rd ed. (Singapore: Cengage, 2009).

Hitt, Michael A., Li, Dan and Xu, Kai. 'International strategy: from local to global and beyond', *Journal of World Business*, vol. 51, no. 1 (2016).

Hoenen, Anne Kristin, and Kostova, Tatiana. 'Utilizing the broader agency perspective for studying headquarters–subsidiary relations in multinational companies', *Journal of International Business Studies*, vol. 46, no. 1 (2015).

Hult, G., Tomas, M., Ketchen, David J., Griffith, David A., Chabowski, Brian R., Hamman, Mary K., Dykes, Bernadine Johnson, Pollitte, Wesley A. and Cavusgil, S. Tamer. 'An assessment of the measurement of performance in international business research', *Journal of International Business Studies*, vol. 39 (September 2008).

Jung, Jae C., Beamish, Paul W. and Goerzen, Anthony. 'Dynamics of experience, environment and MNE ownership strategy', *Management International Review*, vol. 50, no. 3 (2010).

Kobrin, Stephen J. 'Is a global nonmarket strategy possible? Economic integration in a multipolar world order', *Journal of World Business*, vol. 50, no. 2 (2015).

Kostova, Tatiana and Hult, G. Tomas M. 'Meyer and Peng's 2005 article as a foundation for an expanded and refined international business research agenda: Context, organizations, and theories', *Journal of International Business Studies*, vol. 47, no. 1 (2016), pp. 23–32.

Koveshnikov, Alexei, et al. 'A framework of successful organizational practices in Western multinational companies operating in Russia', *Journal of World Business*, vol. 47, no. 3 (2012).

Merchant, Hemant. 'Configurations of international joint ventures', *Management International Review*, vol. 40, no. 2 (2000).

Merchant, Hemant. 'Cooperative strategy: economic, business, and organizational issues', *Academy of Management Review*, vol. 26, no. 2 (April 2001).

Meschi, Pierre-Xavier and Riccio, Edson Luiz. 'Country risk, national cultural differences between partners and survival of international joint ventures in Brazil', *International Business Review*, vol. 17, no. 3 (June 2008).

Meyer, Klaus E. and Peng, Mike W. 'Probing theoretically into Central and Eastern Europe: Transactions, resources, and institutions', *Journal of*

International Business Studies, vol. 36, no. 6 (2005), pp. 600–621.
Mintzberg, Henry, Ahlstrand, Bruce and Lampel, Joseph. *Strategy Safari* (New York: Free Press, 1998).
Mudambi, Susan M. and Tallman, Stephen. ‘Make, buy or ally? Theoretical perspectives on knowledge process outsourcing through alliances’, *Journal of Management Studies*, vol. 47, no. 8 (December 2010).
Narula, Rajneesh and Verbeke, Alain. ‘Making internalization theory good for practice: The essence of Alan Rugman’s contributions to international business’, J*ournal of World Business* vol. 50, no. 4 (2015).
Pak, Yong Suhk, Ra, Wonchan and Lee, Jong Min. ‘An integrated multi-stage model of knowledge management in international joint ventures: identifying a trigger for knowledge exploration and knowledge harvest’, *Journal of World Business*, vol. 50, no. 1 (2015).
Piscitello, Lucia. ‘Multinationals and economic geography: location, technology and innovation’, *Journal of International Business Studies*, vol. 44, no. 8 (2013).
Porter, Michael E. ‘The competitive advantage of nations’, *Harvard Business Review*, vol. 68, no. 2 (March/April 1990).
Puck, Jonas F., Holtbrügge, Dirk and Mohr, Alexander T. ‘Beyond entry mode choice: explaining the conversion of joint ventures into wholly owned subsidiaries in the People’s Republic of China’, *Journal of International Business Studies*, vol. 40 (April 2009).
Ricart, Joan Enric, Enright, Michael J. and Ghemawat, Pankaj. ‘New frontiers in international strategy’, *Journal of International Business Strategy*, vol. 35, no. 3 (May 2004).
Rugman, Alan M. and Verbeke, Alain. *Analysis of Multinational Strategic Management: The Selected Scientific Papers of Alan M. Rugman and Alain Verbeke* (Cheltenham: Edward Elgar, 2005).

Rugman, Alan M. and Verbeke, Alain. ‘The theory and practice of regional strategy: a response to Osegowitsch and Sammartino’, *Journal of International Business Studies*, vol. 39, no. 2 (2008).

Rugman, Alan M. and Verbeke, Alain. ‘A regional solution to the strategy and structure of multinationals’, *European Management Journal*, vol. 26 (2008).

Tallman, Stephen B. and Yip, George S. ‘Strategy and the multinational enterprise.’ In Alan M. Rugman (ed.), *The Oxford Handbook of International Business*, 2nd ed. (Oxford: Oxford University Press, 2009).

Tong, Tony W., and Reuer, Jeffrey J. ‘Competitive consequences of interfirm collaboration: how joint ventures shape industry profitability’, *Journal of International Business Studies*, vol. 41, no. 6 (2010).

Vahlne, Jan-Erik, and Jonsson, Anna. ‘Ambidexterity as a dynamic capability in the globalization of the multinational business enterprise (MBE): Case studies of AB Volvo and IKEA’, *International Business Review*, vol. 26, no. 1 (2017).

Vapola, Terhi Johanna, Paukku, Markus, and Gabrielsson, Mika. ‘Portfolio management of strategic alliances: an international business perspective’, *International Business Review*, vol. 19, no. 3 (June 2010).

Vendrell-Herrero, F., Gomes, E., Collinson, S. and Parry, G. ‘Selling digital services abroad: How do extrinsic attributes influence foreign consumers’ purchase intentions?’ *International Business Review*, vol. 27, no. 1, 173–85 (2018).

Verbeke, Alain, and Kano, Liena. ‘An internalization theory perspective on the global and regional strategies of multinational enterprises’, *Journal of World Business*, vol. 51, no. 1 (2016).

Verbeke, Alain and Yuan, Wenlong. ‘Entrepreneurship in multinational enterprises: a Penrosean perspective’, *Management International*

Review, vol. 47, no. 2 (2007).

APPENDIX: REGIONAL ASPECTS OF MULTINATIONALITY AND PERFORMANCE

The founder of this textbook series, Professor Alan Rugman, was a keen advocate of the need to robustly question established beliefs about the world and to look to the data and other empirical evidence to tell the real story. He focused on a number of key topics in international business studies and one of these was the relationship between multinationality and performance. Here we outline the main argument and provide a series of references which will help you dig more deeply into this topic.

Introduction

A basic premise of international business is that foreign operations are profitable – otherwise, they would not take place! Thus it is hypothesised that the performance of the firm (usually an MNE) improves as its degree of foreign operations increases. Rugman (2005) and subsequent research has shown that (1) there is not a clear-cut correlation between increasing multinationality and performance, and (2) that the world's largest firms operate mainly on an intra-regional basis, not globally, in terms of both sales and assets.

In the field of international business one of the most basic issues is the relationship between multinationality and performance. Several hundred studies have examined the nature of this relationship, with somewhat inconclusive results. The S-curve framework does, however, provide one explanation which has received widespread support. Contractor (2007)

presents a theoretical justification for the three-stage *S* curve (see Figure 8A). The horizontal axis represents the degree of multinationality, here proxied by the ratio of foreign (F) to total (T) sales, (F/T). The vertical axis represents a performance measure, here the return on total assets (ROTA). There is generally a positive relationship between these two variables. In an interesting twist, Contractor argues that the middle stage is consistent with the observations on the regional nature of multinational activity. He also suggests that the final stage, where performance suffers due to excessive multinationality, is typically populated by relatively few firms. This fall-off in performance beyond a certain threshold of multinationality may correspond to an attempt by some companies to reach a 'global' stage.

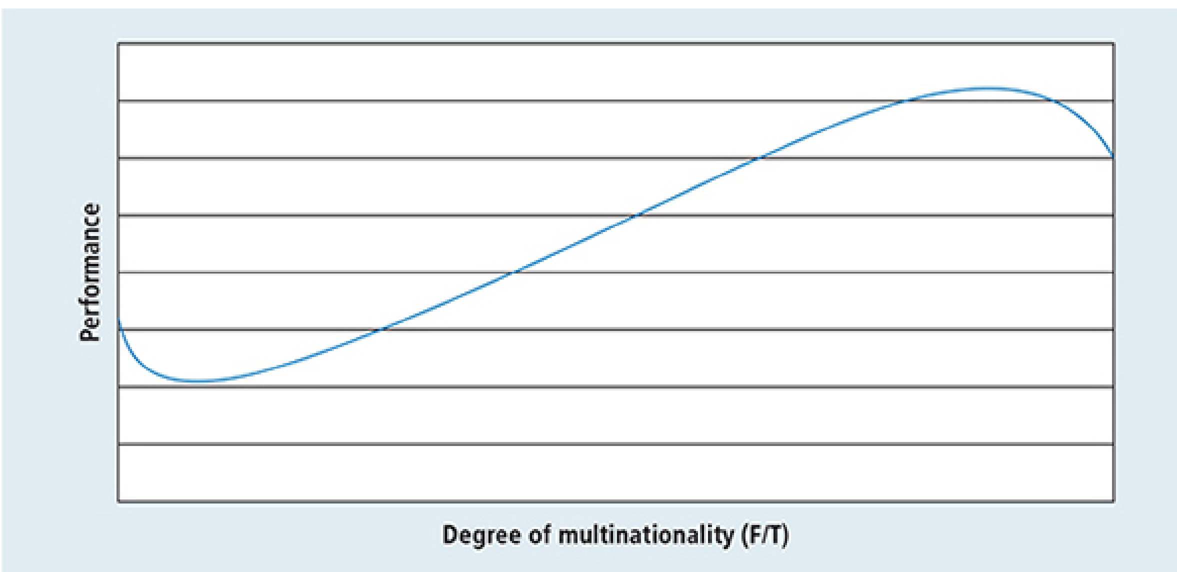

Figure 8A Multinationality and performance

Various analyses of the world's largest 500 or 200 firms using a simple proxy measure of transnationality: the combined ratios of foreign to total sales (FS/TS), foreign to total assets (FA/TA) and foreign to total employees (FE/TE), shows that very few are genuinely global. Most of these firms focus most of their assets, sales and/or employees either in the domestic home market or in the home region (Rugman and Verbeke, 2004, 2007).

Studies of Japanese firms (Collinson and Rugman, 2008; Goerzen and Asmussen, 2007) provided one early explanation for the above findings by showing that many firm-specific advantages (FSAs) tend to be 'location-bound'. That is, the competitive advantages tend to be strongly linked to local factors making it difficult for firms to break into foreign markets (see also, Collinson and Narula, 2014). Specifically marketing FSAs are more location-bound than technological FSAs (R&D asses and capabilities). The latter appear to provide a stronger basis for internationalisation.

Multinationality and performance

Bowen (2007) provides a theoretical critique of the extant empirical work in the multinationality and performance literature. He points out that basic statistical issues have not been resolved, including the issues of endogeneity and non-linearities in the tests. He argues that the multinationality and performance literature does not take into account the heterogeneous nature of firms, industries, or countries. Bowen argues further that the multinationality and performance literature needs to be much better integrated into basic international business theory and that the various 'modes of multinationality' (exporting, FDI, outsourcing) can affect measurement.

Fortanier et al. (2007) offer a cautionary tale for researchers on multinationality and performance. They find that the empirical results testing this relationship are strongly affected by moderating variables. In particular, the so-called 'strategic fit' affects performance in a significant and positive manner. Strategic fit moderates the basic aspects of multinationality and performance including the shape, size and direction of the relationship. Strategic fit is based upon the integration and national responsiveness framework, which is also used by Li and Li (2007).

Kumar and Gaur (2007) examine the relationship between multinationality and performance within the context of 240 of India's MNEs, many of which are smaller firms than the world's largest 500 for which the regional effect has been tested. They find strong evidence of a positive J-shaped exponentially increasing relationship between the internationalisation of Indian firms and their performance. They also find that India's outward FDI differs between developing and developed economies, and between manufacturing and service sectors. A key contribution is that their data include relatively small and medium-sized firms, not just the world's largest 500 firms. This helps us better understand the country context in studies of multinationality and performance, as India has many small multinational firms. Usually size of firms is a moderating or control variable, but Kumar and Gaur link it to a country factor for India.

Li and Li (2007) provide an innovative test of the regional aspects of multinationality and performance. The authors use the well-known integration and responsiveness matrix to distinguish between a 'global' industry, which has a high degree of economic integration, and a 'multidomestic' industry, which is nationally responsive. They choose the computer and office equipment industry as an example of a global industry, and the soap, cleanser and toilet goods industry as an example of a multidomestic industry. They find significant differences between the two industries in terms of international strategies, which lead to confirmation of the regional dimension in multinational operations. Li and Li also test the impact of FSAs in the two industries in terms of both R&D and marketing intensity. Their results indicate that FSAs are largely non-location bound in the global industry, but much home-region bound in the multidomestic industry. In addition, they show that internationalisation pace has a direct positive impact on firm performance in the global industry but not in the multidomestic industry.

It would be useful to extend this type of research beyond the largest 100 firms (or the 500 largest in Rugman (2005)) to include many more MNEs that are small to medium sized. Indeed, it would be useful to test the regional dimension in the emerging literature on international entrepreneurship, some of which is focused upon the internationalisation process of small and medium-sized firms. This will require some theoretical adjustments to the assumption that many of these firms are 'born global'.

While this work on international entrepreneurship remains to be undertaken, this recent empirical work provides a very useful starting point in bringing the regional nature of MNEs into the literature on multinationality and performance. There is uniformity in showing that the basic relationship between multinationality and performance is beset by issues of heterogeneity across countries, industries and firms. Yet many of them also show that the regional nature of multinationality can be included in this work in a useful manner. Therefore, the regional dimension of strategy needs to be considered in future work analysing the relationship between multinationality and performance.

References

Bausch, A., Fritz, T. and Bösecke, K. 'Performance effects of internationalization strategies: a meta-analysis.' In A. M. Rugman (ed.), *Regional Aspects of Multinationality and Performance* (Oxford: Elsevier, 2007).

Bowen, H. P. 'The empirics of multinationality and performance.' In A. M. Rugman (ed.), *Regional Aspects of Multinationality and Performance* (Oxford: Elsevier, 2007).

Carney, M., Gedajlovic, E. R., Heugens, P. P., Van Essen, M. and Van Oosterhout, J. H. 'Business group affiliation, performance, context, and

strategy: a meta-analysis', *Academy of Management Journal*, vol. 54, no. 3 (2011).

Chen, S. 'Testing regional effects in the internationalization–performance relationship in Asia service firms.' In A. M. Rugman (ed.), *Regional Aspects of Multinationality and Performance* (Oxford: Elsevier, 2007).

Collinson, S.C. and Narula, R., Asset recombination in international partnerships as a source of improved innovation capabilities in China, *Multinational Business Review*, 22, 4, pp. 394–417 (2014).

Collinson, S.C. and Rugman, A.M. 'The Regional Nature of Japanese Multinational Business', *Journal of International Business Studies* (JIBS), vol. 39, no. 2, pp. 215–30 (2008).

Contractor, F. J. 'The evolutionary or multi-stage theory of internationalization and the regionalization of firms.' In A. M. Rugman (ed.), *Regional Aspects of Multinationality and Performance* (Oxford: Elsevier, 2007).

Fortanier, F., Muller, A. and Tulder, R. van. 'Internationalization and performance: the moderating role of strategic fit.' In A. M. Rugman (ed.), *Regional Aspects of Multinationality and Performance* (Oxford: Elsevier, 2007).

Goerzen, A. and Asmussen, C. G. 'The geographic orientation of multinational enterprises and its implications for performance.' In A. M. Rugman (ed.), *Regional Aspects of Multinationality and Performance* (Oxford: Elsevier, 2007).

Hejazi, W. 'The regional nature of MNE activities and the gravity model.' In A. M. Rugman (ed.), *Regional Aspects of Multinationality and Performance* (Oxford: Elsevier, 2007).

Kirca, A. H., Hult, G. T. M., Roth, K., Cavusgil, S. T., Perryy, M. Z., Akdeniz, M. B. and Miller, J. C. 'Firm-specific assets, multinationality,

and financial performance: a meta-analytic review and theoretical integration', *Academy of Management Journal*, vol. 54, no. 1 (2011).

Kumar, V. and Gaur, A. S. 'Internationalization and performance of Indian firms.' In A. M. Rugman (ed.), *Regional Aspects of Multinationality and Performance* (Oxford: Elsevier, 2007).

Li, L. and Li, D. 'Testing the global and regional strategies of multinational enterprises.' In A. M. Rugman (ed.), *Regional Aspects of Multinationality and Performance* (Oxford: Elsevier, 2007).

Martin, R.L. 'Strategy is about both resources and positioning', *Harvard Business Review* (27 April 2015). https://hbr.org/2015/04/strategy-is-about-both-resources-and-positioning

Nachum, L. and Wymbs, C. 'The location and performance of foreign affiliates in global cities.' In A. M. Rugman (ed.), *Regional Aspects of Multinationality and Performance* (Oxford: Elsevier, 2007).

Oh, C.-H., Li, J. 'Commentary: Alan Rugman and the theory of the regional multinationals', *Journal of World Business*, vol. 50, no. 4 (2015).

Oh, C.-H. and Rugman, A. M. 'Multinationality and regional performance, 2001–2005.' In A. M. Rugman (ed.), *Regional Aspects of Multinationality and Performance* (Oxford: Elsevier, 2007).

Osegowitsch, T. and Sammartino, A. 'Exploring trends in regionalization.' In A. M. Rugman (ed.), *Regional Aspects of Multinationality and Performance* (Oxford: Elsevier, 2007).

Richter, N. 'Intra-regional sales and the internationalization and performance relationship.' In A. M. Rugman (ed.), *Regional Aspects of Multinationality and Performance* (Oxford: Elsevier, 2007).

Rugman, A. M., Chang, H. O. and Dominic, S. K. L. 'The regional and global competitiveness of multinational firms', *Journal of the Academy of Marketing Science*, vol. 40, no. 2 (2012).

Rugman, Alan M. and Verbeke, Alain. ‘A perspective on regional and global strategies of multinational enterprises’, *Journal of International Business Studies*, vol. 35, no. 1 (January 2004), pp. 3–18.

Rugman, A. M. and Verbeke, Alain. ‘Liabilities of regional foreignness and the use of firm-level versus country-level data: a response to Dunning *et al.* (2007)’, *Journal of International Business Studies*, vol. 38, no. 1 (January 2007).

Rugman, A. M., Yip, G. S. and Kudina, A. ‘The regional dimension of UK multinationals.’ In A. M. Rugman (ed.), *Regional Aspects of Multinationality and Performance* (Oxford: Elsevier, 2007).

Sukpanich, N. ‘Intra-regional sales and performance.’ In A. M. Rugman (ed.), *Regional Aspects of Multinationality and Performance* (Oxford: Elsevier, 2007).

Verbeke, A., Li, L. and Goerzen, A. ‘Toward more effective research on the multinationality–performance relationship’, *Management International Review*, vol. 49, no. 2 (2009).

Additional bibliography

Banalieva, E. and Santoro, M. ‘Local, regional, or global? Geographic orientation and relative financial performance of emerging market multinational enterprises’, *European Management Journal*, vol. 27, no. 5 (2009).

Beleska-Spasova, E. and Glaister, K. W. ‘Geographic orientation and performance’, *Management International Review*, vol. 50, no. 5 (October 2010).

Chen, S. and Tan, H. ‘Region effects in the internationalization–performance relationship in Chinese firms’, *Journal of World Business* (2010).

Oh, C. H. ‘The international scale and scope of European multinationals’, *European Management Journal*, vol. 27, no. 5 (2009).

Oh, C. H. ‘Value creation and home region internationalization of US MNEs’, *Multinational Business Review*, vol. 18, no. 4 (2010).

Oh, C. H. and Rugman, A. M. ‘Regional integration and the international strategies of large European firms’, *International Business Review*, vol. 21, no. 3 (2012).

Peng, M. *Global Business* (South-Western College Publishing, 2016).

Qian, G., Khoury, T., Peng, M. W. and Qian, Z. ‘The performance implication of intra- and inter-regional geographic diversification’, *Strategic Management Journal*, vol. 31 (2010).

Rugman, A. M. and Oh, C. H. ‘Does the regional nature of multinationals affect the multinationality and performance relationship?’ *International Business Review*, vol. 19, no. 5 (2010).

Rugman, A. M. and Oh, C. H. ‘Methodological issues in the measurement of multinationality of US firms’, *Multinational Business Review*, vol. 19, no. 3 (2011).

Rugman, A. M. and Oh, C. H. ‘Why the home region matters: location and regional multinationals’, *British Journal of Management*, vol. 24, no. 4 (2013).

Rugman, A. M. and Verbeke, A. ‘Internalization theory and its impact on the field of international business.’ In J. J. Boddewyn (ed.), *International Business Scholarship: AIB Fellows on the First 50 Years and Beyond*, Research in Global Strategic Management, vol. 14 (Bradford: Emerald Group, 2008).

Rugman, A. M., Yip, G. S. and Kudina, A. ‘Testing the link between multinationality and the return on foreign assets’, *Multinational Business Review*, vol. 17, no. 3 (2009).

Sullivan, Daniel. ‘Measuring the degree of internationalization of a firm’, *Journal of International Business Studies*, vol. 25, no. 2 (1994).

Verbeke, A. and Brugman, P. ‘Triple-testing the quality of multinationality–performance research: an internalization theory perspective’, *International Business Review*, vol. 18, no. 3 (June 2009).

Verbeke, A., Li, L. and Goerzen, A. ‘Toward more effective research on the multinationality–performance relationship’, *Management International Review*, vol. 49, no. 5 (2009).

Wolf, J., Dunemann, T. and Egelhoff, W. G. ‘Why MNCs tend to concentrate their activities in their home region’, *Multinational Business Review*, vol. 20, no. 1 (2012).

Yuan, L. and Pangarkar, N. ‘Performance implications of internationalization strategies for Chinese MNCs’, *International Journal of Emerging Markets*, vol. 10, no. 2 (2015).

Chapter 9

ORGANISING STRATEGY

Contents

Objectives of the chapter

Strategy and structure go hand-in-hand. A firm's strategic options are limited by its existing structures and its future structure is the result of its current strategy. The primary purpose of an organising strategy is to help an enterprise implement its strategic plan. There are a number of basic organisation structures from which to choose, although most MNEs tailor-make their design and sometimes use a combination of different structures. As well as the organisational structure of a firm,

the organisational processes of decision making, communicating and controlling are central to its organising strategy. This chapter examines the key elements of organising strategy.

The specific objectives of this chapter are to:

1 *Examine* organisation structures used by enterprises that are just beginning their international expansion.

2 *Describe* the international division and global structures that are used as firms increase their international presence.

3 *Analyse* the key structural variables that influence international organisation designs.

4 *Review* the role of the organisational processes in ensuring that the structure is both effective and efficient.

ACTIVE LEARNING CASE

Procter & Gamble

In 1837, William Procter, a candle maker, and his brother-in-law James Gamble, a soap maker, partnered to create a company that would manufacture and market soaps and candles from its base in Cincinnati, Ohio. When candles declined in popularity with the invention of the light bulb and production was eventually discontinued in the 1920s, soap became the basis from which the company built a successful product portfolio of cleaning products and eventually allowed Procter & Gamble to branch out into cosmetics, food and pet products.

During P&G's first century, international expansion was an afterthought. In 1915, a Canadian plant was established, the first outside the United States. P&G's first overseas subsidiary was established with the purchase of Thomas Hedley & Sons Co., Ltd. in England in 1930. This coincided with the birth of P&G's brand management marketing system. Dedicated teams would work on marketing competing brands worldwide. In 1948, P&G established an overseas division to manage its growing international division, which at the time reached Asia, Europe and Latin America. By 1963, as a result of European expansion, P&G established the European Technical Center in Belgium to serve common market subsidiaries. The Japanese market was entered in 1973 through the acquisition of the Nippon Sunhome Company, and in 1993 the Japan Headquarters and Technical Center opened in Rokkō Island in Kobe City.

By 1995, sales outside the United States had reached more than 50 per cent of total sales, and a new top management team, headed by John E. Pepper, changed the organisation structure of the firm, from 'US and International' to four regional sectors: North America; Latin America; Asia; and Europe, the Middle East, and Africa. All regional sectors reported to the chief operating officer.

By 2004, P&G had the workings of a global company in terms of its structure. Three interactive parts, with subsidiaries strategically placed around the world to achieve cost-effectiveness, marketing and production, and design quality, were the basis of this structure. First, there were seven Market Development Organisations (MDOs) responsible for marketing products in the following regions: North America; ASEAN, India, Australia; China; North-East Asia; Central and Eastern Europe, the Middle East, and Africa; and Western Europe and Latin America. Second, these MDOs

collaborated with any one of five product-based Global Business Units (GBUs) responsible for R&D, design, and the manufacturing processes. Third, there were Global Business Services (GBSs) located mainly in developing countries that provided accounting, human resource management, logistics and system operations in a given region. Finally, a Corporate Functions (CF) segment oversaw operations but delegated decision making to each structural unit.

This basic structure was kept for over 10 years. In 2015, the GBUs had reduced to four: Baby, Feminine and Family Care; Beauty; Fabric and Home Care; and Health and Grooming. The MDOs were renamed 'Selling and Market Operations' or SMOs, with dedicated retail customer and country-specific teams. There were six: Asia Pacific; Europe; Greater China; India and the Middle East and Africa (IMEA); Latin America; and North America. The GBS has also evolved to 'provide technology, processes and standard data tools to enable the GBUs and the SMOs to better understand the business and better serve consumers and customers' (http://us.pg.com/who_we_are/structure_governance/corporate_structure).

In Figure 9.8, the SMOs are equivalent to marketing-based Area Profit Centres; the GBUs can be placed where the Business Profit Centres are. The GBSs, in turn, can take the place of Function Cost Centres. These three sectors interact with each other under the guidance of Corporate Functions.

This global three-axis matrix structure, however, has not resulted in an even distribution of sales across all three regions of the triad, or across P&G's seven-region segmentation. As of 2018, P&G had approximately 100,000 employees and was ranked as the 135th largest company by sales ('Fortune Global 500', 2017) with total revenue of US $66 billion. A closer analysis indicates that in 2017 revenues in North America were 44 per cent, Europe 24 per cent, Asia Pacific 9 per cent, Greater China 9 per cent, Latin America 7 per cent, and India, Middle East & Africa (IMEA) 7 per cent.

The firm's most important firm-specific advantage (FSA) is its ability to market products in multiple regions. It does this through product adaptation, marketing and packaging to the needs of customers in diverse regions, and by creating successful brands. In 2014, the firm's top 70–80 brands (e.g. Tide, Ariel, Pantene and Crest) were leaders within each respective industry and accounted for approximately 90 per cent of P&G sales.

P&G's strategy does not necessarily include developing global brands like Pringles, its most globally diversified brand. Instead, the firm might choose locally trusted brands to channel new products to multiple regions. Blendax, a European brand, is now the portal through which P&G markets Whitestrips, which are sold in North America under the Crest brand. Many successful brands were carefully picked up through acquisitions and then revamped with new marketing. Between 1980 and 2000, P&G acquired CoverGirl, Noxzema, Clarion, Oil of Olay, Blendax, Old Spice, Max Factor and Pantene, among others. In other words, the firm finds regional brands to develop regionally.

Another firm-specific advantage is that P&G's large portfolio of products gives it economies of scale in R&D; scientific breakthroughs and new technologies can be exploited across different product lines in all regions. For example, a fabric detergent discovery may create improved versions of Tide and Cheer in North America, Ariel in Latin America and Bold in Japan. It might also 'spill over' to non-fabric cleaners such as Salvo. This, and the GBUs' ability to coordinate production across the world, translate into scale economies that are difficult to rival in the industry.

P&G has gone further than most companies in creating a global structure that incorporates developing and emerging countries. For example, as far back as 2004, the GBS for the Americas was located in Costa Rica, while that in the Philippines provides services to the Asian region. Factories are located in Asia, eastern Europe and Latin America, as well as in more developed countries. R&D, usually reserved for developed nations, has also seen its way to developing countries like China.

Websites: www.pg.com; http://fortune.com/global500/procter-gamble-100/; http://us.pg.com/who_we_are/structure_governance/corporate_structure

Sources: Alan Rugman, *The Regional Multinationals* (Cambridge: Cambridge University Press, 2005); P&G, *Annual Report*, 2010, 2014, 2018; 'Fortune Global 500', *Fortune*, 26 July 2010.

1. **What type of organisation structure does P&G have in place for its worldwide operations? Is this structure optimal?**
2. **Why was the international division replaced by the matrix structure?**

3. **Why does the company rely on decentralised decision making?**
4. **In controlling its operations, what are three areas that are paramount for the firm?**

INTRODUCTION

This chapter on organisation strategy is intimately related to the previous chapter on strategic management. Indeed, there is an unresolved debate about whether strategy follows structure or whether structure follows strategy. We do not need to resolve this debate, but simply to recognise the interconnections between strategy and structure. As shown in the introduction to the previous chapter, it is essential to link the issues of organisation structure to the previous frameworks of international business. In particular, the FSA–CSA matrix of Chapter 2 is relevant. Also remember the internationalisation roadmap or decision tree introduced at the start of the book (see Figure 2 in the section 'Frameworks for this Book'), this links individual strategic decisions to the evolving structure of the enterprise as it internationalises.

In this chapter we will see that many firms operate in a centralised and hierarchical manner. These structures are suitable for firms pursuing strategies of economic integration, for example, where worldwide economies of scale are being obtained. As was shown in the previous chapter, a strategy of economic integration can occur in cell 1 of the FSA–CSA matrix. By the end of this chapter the student will realise that a centralised and hierarchical structure is usually followed by firms pursuing a cell 1 strategy of economic integration.

In contrast, firms which pursue marketing strategies and differentiate their products and/or services by building strong brand names are best positioned in cell 4 of the FSA–CSA matrix. In cell 4, where FSAs are divorced from CSAs, the appropriate organisation structure need not be one of hierarchy. A multinational firm may need to adapt its product or service to various foreign

markets. This strategy of national responsiveness (discussed in Chapter 10) may require a decentralised organisation structure, one where more autonomy is given to subsidiary managers.

Finally, in cell 3 of the FSA–CSA matrix it may be necessary to combine the advantages of both a centralised and decentralised organisation structure. Somewhat paradoxically, this is often called a matrix structure. Such a matrix organisation structure, where complementary assets need to be combined, is consistent with a strategy in cell 3 of the FSA–CSA matrix.

This chapter will now examine the various types of organisation structures available to the senior management teams of multinational enterprises. We also examine how business networks can be managed. This thinking on strategy and structure is then applied in subsequent chapters to issues in production (Chapter 11); marketing (Chapter 12); human resource management (Chapter 13); political risk negotiations (Chapter 14); and international financial management (Chapter 15). This will then be applied as an example of regional strategy in the final set of chapters.

Organisations that have decided to expand internationally do so in a number of ways. Some simply ship their goods to a foreign market and have a third party handle sales activities. If a firm's international market is a large portion of its total operations, however, the enterprise may play a more active role in the distribution and sale of its products, and this requires a more complex organisation structure. Often, firms start off as exporters and then, as their foreign sales grow, develop more intricate structures that can handle their foreign operations.[1]

Major MNEs such as IBM, General Motors, HSBC, Mercedes and Mitsubishi have sophisticated global structures that form the basis of their organising strategies. Sometimes these firms will also have subsidiaries or affiliates that are integrated into the overall structure. For example, Mitsubishi has 28 core groups that are bound together by cross-ownership and other

financial ties, interlocking directorates, long-term business relationships, and social and historical ties. Among these are Mitsubishi Bank, Mitsubishi Heavy Industries, Asahi Glass, Tokyo Marine and Fire Insurance, Nikon Corporation and Kirin Brewery. The Mitsubishi Group obviously needs a carefully designed global structure that allows it to integrate and coordinate the activities of these many businesses. Sometimes this undertaking involves more time and effort than the formulation of the strategic plan.

ORGANISATION STRUCTURES

Multinational enterprises cannot implement their strategies without an effective structure. The strategy sets out the plan of action, but the structure is critical in ensuring that the desired goals are met efficiently. A number of choices are available to an MNE when deciding on an organisational arrangement, and a number of factors can influence this choice. For example, firms that are just getting into the international arena are likely to choose a structure that differs from that of firms with established overseas operations. Conversely, companies that use their structures as worldwide sales organisations will have a different arrangement from those that locally manufacture and sell goods in various international markets. International structures will change in compliance with the strategic plan, and a structure that is proving to be unwieldy or inefficient will be scrapped in favour of one that better meets the needs of the company. The following discussion examines some of the most common organisational arrangements used by MNEs.

Early organisation structures

When a company first begins international operations, such activities are typically extensions of domestic operations. The firm's primary focus continues to be the local market; international involvement is of secondary importance. International transactions are conducted on a case-by-case basis, and there is no attempt to consolidate these operations into a separate department. Under this arrangement, international sales are viewed as supplements to the income earned from home-country operations.

As international operations increase, however, the MNE will take steps to address this growth structurally. One way is by having the marketing department handle international sales. All overseas operations are coordinated through this department; if sales warrant it, some of the salespeople will handle international transactions exclusively. In this way the company develops marketing specialists who learn the specific needs and marketing techniques to employ in overseas selling.

An alternative arrangement is to create an export department. This department may report directly to the chief executive officer (CEO) (Figure 9.1, line (*a*)) or be a sub-department within the marketing area (Figure 9.1, line (*b*)). If it operates independently of the marketing department (option (*a*)), it is either staffed by in-house marketing people whose primary focus is on the international market or operated by an outside export management company that is hired to provide the company with an international arm. Whichever approach is taken, MNEs planning to increase their international presence must ensure that the export department is a full-fledged marketing department and not just a sales organisation.

Another possible arrangement is the use of overseas subsidiaries (see Figure 9.2). This is often a result of individual ventures in various geographic locales in which the head of the venture is given a great deal of autonomy and reports directly to the CEO. As long as the subsidiary shows sufficient profit, it is allowed to operate free from home-office interference.

As MNEs become more involved in foreign markets, the export department structure or subsidiary arrangement is generally discarded or supplemented because it cannot meet the organisation's changing needs. As a result, the company will now look into joint ventures[2] and foreign direct investment, likely opting for an international division structure. To examine one company's international organisation structure, see the case **International Business Strategy in Action: Sanofi-Aventis**.

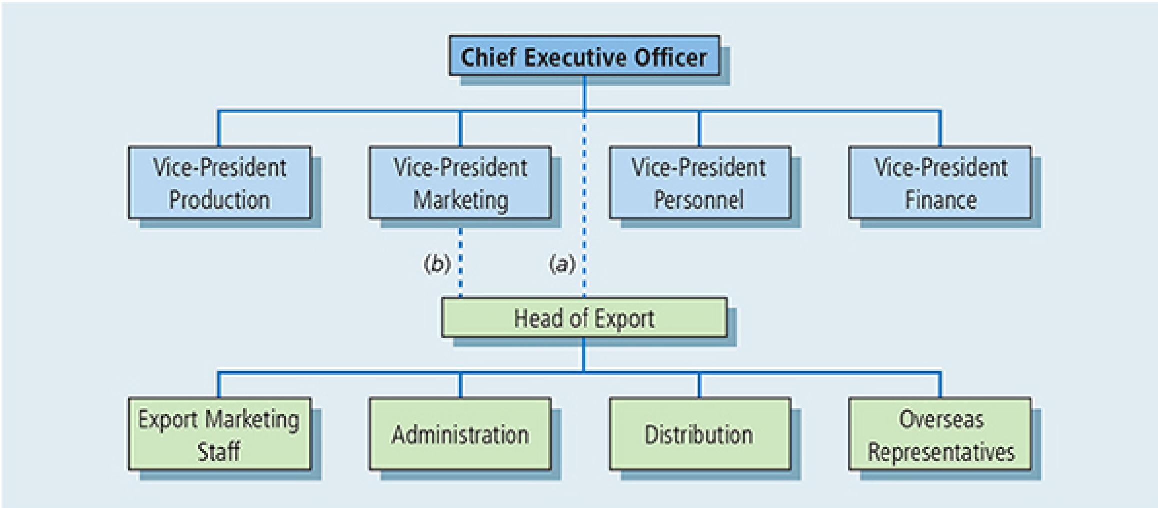

Figure 9.1 An export department structure

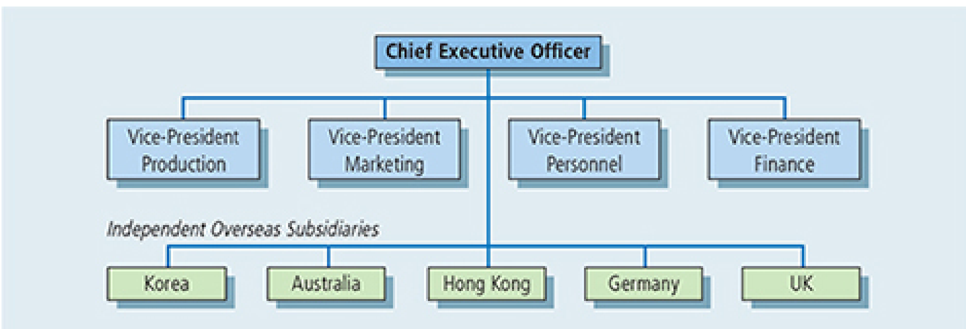

Figure 9.2 Use of subsidiaries during the early stages of internationalisation

INTERNATIONAL BUSINESS STRATEGY IN ACTION

Sanofi-Aventis

The French firm Sanofi-Synthelabo acquired Aventis, its most important and much larger French rival, in 2004, at the time creating the sixth largest pharmaceutical company in the world, Sanofi-Aventis. The new company is the result of a succession of approximately ten major mergers and acquisitions. Aventis itself was the product of a 1999 merger between French Rhône-Poulenc and Hoechst of Germany.

Sanofi-Aventis is a pharmaceutical group engaged in the research, development, manufacture and marketing of healthcare products. Its business includes two main activities: pharmaceuticals and human vaccines through Sanofi Pasteur. It is also present in animal health products through Merial Limited (Merial). In its pharmaceutical activity, it specialises in six therapeutic areas: diabetes, oncology, thrombosis, cardiovascular, central nervous system (CNS) and internal medicine. The global portfolio of Sanofi-Aventis also consists of a range of other pharmaceutical products in Consumer Health Care (CHC) and other prescription drugs, including generics. It offers vaccines in five areas: paediatric combination vaccines, influenza vaccines, adult and adolescent booster vaccines, meningitis vaccines, and travel and endemic vaccines.

In 2018, Sanofi-Aventis had total revenues of $39.07 billion, making it the eighth largest pharmaceutical company in the world (see Table 9.1). The company is still based in France, but most of its sales are to foreign markets. In 2017, Europe accounted for 27 per cent of its sales, the United States for 34 per cent, emerging markets for 29 per cent, and the rest of the world for 10 per cent.

Mergers in the pharmaceutical industry are the result of increasing pressures to consolidate in order to achieve further economies of scale in R&D, marketing and distribution. Aventis itself had managed to become one of the major competitors in its industry through mergers and acquisitions. Back in the mid-1980s Rhône-Poulenc was the twelfth largest chemical firm in the world, with 80 per cent of sales being generated in Europe. In this environment, it competed with a large number of firms, including US-based giants DuPont and Dow Chemical, and leading European chemical companies such as Hoechst, BASF, Ciba-Geigy and ICI.

Source: THOMAS WIRTH/Stringer/AFP/Getty Images

During this period, the chemical industry was being increasingly structured on a 'triad' basis. As a result, Rhône-Poulenc decided to consolidate its successful European base and move into the North American market. In the late 1980s the firm made 18 acquisitions in the United States, including Union Carbide Agrochemical Products and Stauffer Basic Chemicals. These acquisitions made the company the seventh largest chemical manufacturer in the world, generating over 20 per cent of its total sales in the US market.

Table 9.1 World's ten largest pharmaceutical companies, 2018 (based on revenue)

Rank	Company	Country of origin	Revenue (US$bn)
1	Johnson & Johnson	United States	81.60
2	Roche	Switzerland	56.86
3	Pfizer	United States	53.60
4	Novartis	Switzerland	51.90
5	Bayer	Germany	45.06
6	Merck	United States	42.30
7	GlaxoSmithKline	United Kingdom	39.90
8	Sanofi	France	39.07
9	AbbVie	United States	32.75
10	Abbott Laboratories	United States	30.60

Managing its US operations was not easy. The takeover of Union Carbide worked pretty well because the latter's pesticide products were complementary to those of Rhône-Poulenc's herbicides and fungicides, and its corporate culture was similar. However, the Stauffer acquisition proved to be

more difficult because there were overlapping product lines and the US managers at Stauffer had little international experience.

To improve the efficiency of its diverse US operations, Rhône-Poulenc adapted a highly decentralised organisation structure, consolidating its US business operations into a US country group with headquarters at Princeton, New Jersey. The firm also established English as the official language of the company, even though its parent company was French. And as an intermediate step on the path towards true globalisation, the firm's US regional headquarters served to create a strong US presence in the face of vigorous competition from rivals with both efficient production and effective staffing. Rhône-Poulenc's plan for the future was to create a 'transnational' structure.

The new Sanofi-Aventis can take advantage of the steps already taken by Aventis and its predecessor, Rhône-Poulenc, to maintain a strong presence in the US market.

Websites: http://en.sanofi-aventis.com; www.dupont.com; www.dow.com; www.hoechst.com; www.basf.com; www.ciba.com; www.novartis.com; www.ici.com; https://www.biospace.com/article/abbott-reports-2018-results-and-issues-strong-forecast-for-2019/; https://news.abbvie.com/news/press-releases/abbvie-reports-full-year-and-fourth-quarter-2018-financial-results.htm; https://www.sanofi.com/-/media/Project/One-Sanofi-Web/Websites/Global/Sanofi-COM/Home/en/investors/docs/press-releases/Q42018results.pdf?la=en&hash=CDCE30350F0C658C000A909535AD9AF636A93560; https://www.biospace.com/article/merck-announces-fourth-quarter-and-full-year-2018-financial-results/; https://www.gsk.com/media/4629/fy-2017-results-announcement.pdf; https://www.annualreport2018.bayer.com/at-a-glance/fiscal-year-2018.html?pk_campaign=startseite&pk_source=Kennzahlen-btn-1#/datasheet-bayer_ar_oekonomisch/vertbar/0/0,1,2,3,4/figures/0; https://www.novartis.com/sites/www.novartis.com/files/q4-2018-media-release-en.pdf; https://s21.q4cdn.com/317678438/files/doc_financials/Quarterly/2018/q4/Q4-2018-PFE-Earnings-Release.pdf; https://www.roche.com/investors/updates/inv-update-2018-02-01.htm; https://www.jnj.com/johnson-johnson-reports-2018-fourth-quarter-results.

Sources: D. Hunter, 'Reshaping Rhône-Poulenc', *Chemical Week*, vol. 156, no. 23 (1995), p. 30; Alan M. Rugman, *The Regional Multinationals: MNEs and 'Global' Strategic Management*

(Cambridge: Cambridge University Press, 2005); Matthew Herper, 'Why Bristol and Sanofi shouldn't merge', *Forbes*, 2 February 2007; 'Fortune Global 500', *Fortune*, 2010; Fortune, 2018, Thomson Reuters, *OneSource*, 2011.

The international division

The **international division structure** centralises all international operations (see Figure 9.3), an arrangement that offers a number of advantages. First, it reduces the CEO's burden of direct operation of overseas subsidiaries and domestic operations. Second, it creates a management team that prioritises overseas operations. All information, authority and decision making related to foreign efforts is channelled to this division, so there is one central clearing point for international activities. This structure also helps the MNE to develop a cadre of internationally experienced managers.

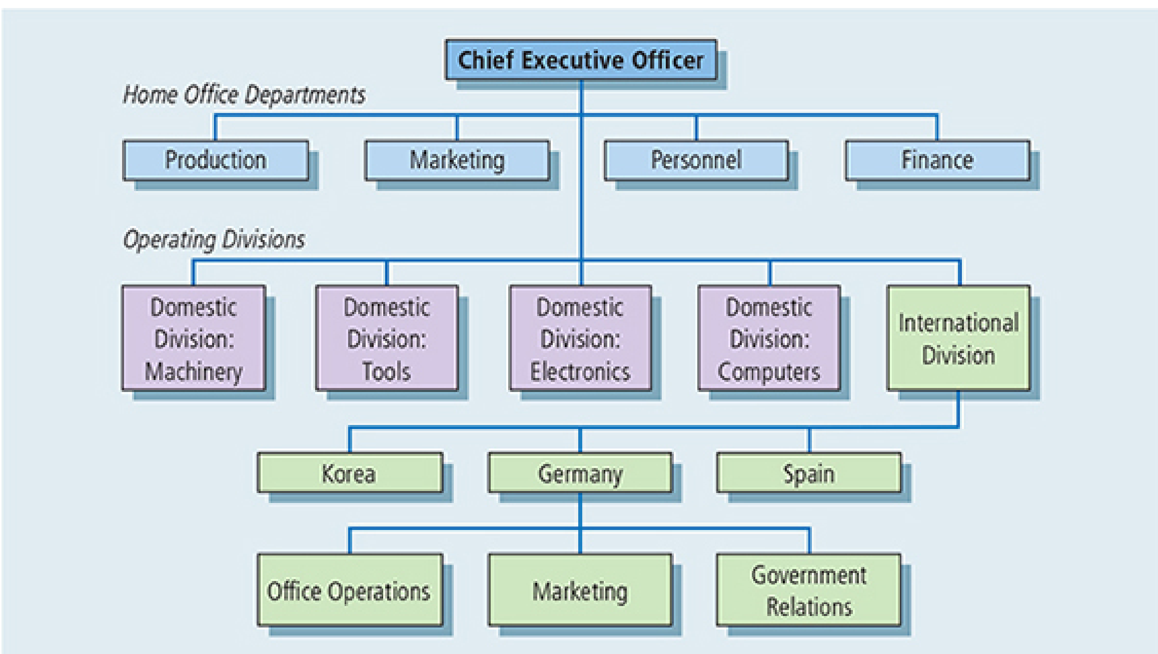

Figure 9.3 An international division structure

But the international division structure also has some significant drawbacks. One is that separating operations into two categories, domestic

and international, can create rivalries between the two. Second, this arrangement puts pressure on the home office to think in global terms and to allocate resources on the basis of overall market opportunity. This can be extremely difficult for a management that has been domestically focused and makes the majority of its sales in the home market. Despite these drawbacks, the international division structure remains dominant among US MNEs.

Global organisation structures

As MNEs generate more and more revenues from their overseas operations, their strategies become more global in focus and the structures used to implement them follow suit. European firms are a good example. Because their domestic markets are fairly small, these companies have traditionally had global structures. In all, there are six basic types: (1) global product; (2) global area; (3) global functional; (4) matrix; (5) mixed; and (6) transnational network.

Global product structure

A **global product structure** is an arrangement in which domestic divisions are given worldwide responsibility for product groups. Figure 9.4 provides an example. In this arrangement, each product division sells its output throughout the world. As seen in the case of Product Division C, the European group operates in a host of countries. The same would be true for the other four geographic areas noted. In each case, the manager of the product division would have internal functional support for the entire product line. All production, marketing, personnel and finance activities associated with Product C would be under the control of this individual. In recent years, Procter & Gamble has used this arrangement to market its wide assortment of products, from paper goods to beauty care, whereas Ford Motor Company has

worked to establish a single automotive operation that relies on a global product structure.

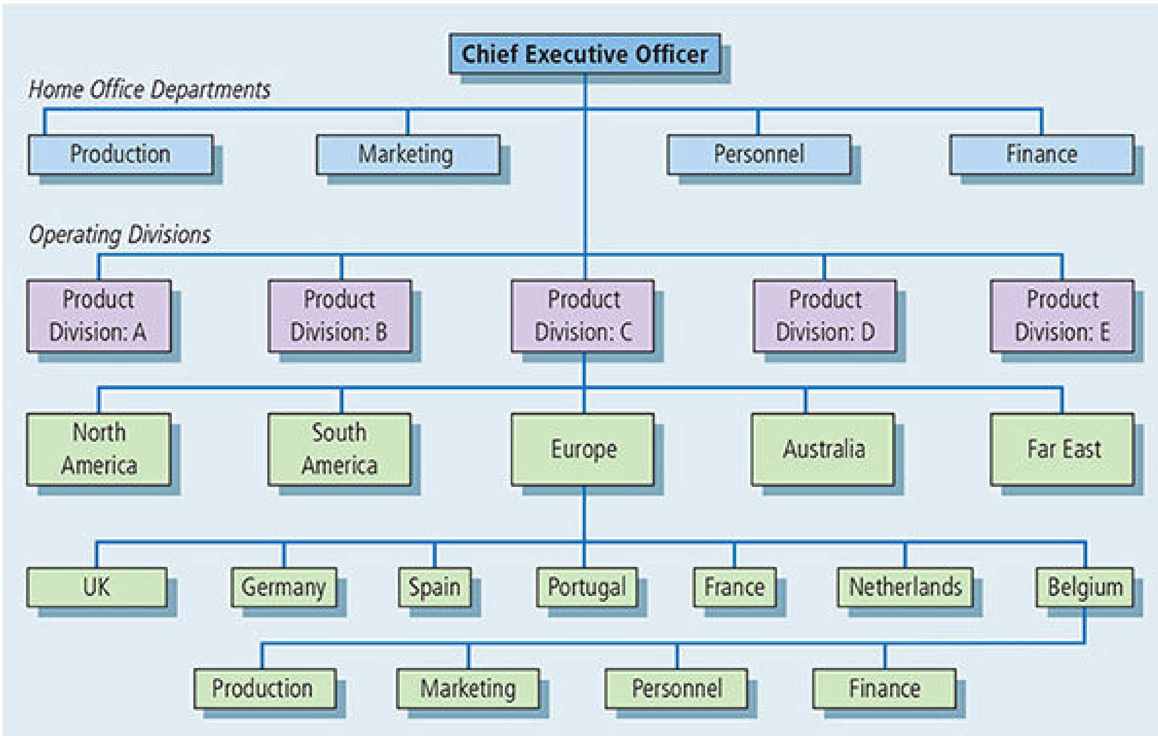

Figure 9.4 A global product structure

This arrangement employs a product division structure that relies on the 'profit centre' concept. Each product line is expected to generate a predetermined return on investment (ROI), and the performance of each line is measured on this profit basis. Each product line is also operated like an autonomous business, with the product division manager having a great deal of authority over how to run the operation. As long as the product line continues to generate the desired ROI, the division is usually allowed to operate unfettered by home-management controls. The only major exception is budgetary constraints that are imposed by central management.

A global product division structure has several benefits. If the firm produces a large number of diverse products, the structure allows each major product line to focus on the specific needs of its customers, which would be

particularly difficult to achieve if the company were trying to sell all these products out of one centralised marketing department. The structure also helps develop a cadre of experienced, well-trained managers who understand a particular product line. And it helps the company match its marketing strategy to specific customer needs. For example, a product may be in the introduction stage in some areas of the world, and in the growth, maturity or decline stage in others. These differing life cycles require close technological and marketing coordination between the home market and the foreign market, which can best be achieved by a product division approach. The product structure also helps the organisation establish and maintain the necessary link between the product development people and the customer. By continually feeding back information from the field to the home office, product division personnel ensure that new product offerings meet consumer needs.

There are also disadvantages of the product division arrangement. One is the necessity of duplicating facilities and staff personnel within each division. A second is that products that sell well are often given primary attention, while those that need special handling or promotion are often side-tracked, even though this may result in the long-run loss of profit. A third is that an effective product division requires managers who are knowledgeable about the worldwide demand for their products. Most managers know the local market but do not know a lot about international markets. So it takes time to develop the necessary managerial staff to run this type of structure. A fourth shortcoming is the difficulty of coordinating the activities of different product divisions. For example, the electronics division may decide to subcontract components to a plant in Germany, while the computer division is subcontracting work to a firm in France. If the two divisions had coordinated their activities, it might have been possible to have all the work done by one company at a lower price. Finally, lack of cooperation among the various product lines can result in lost sales, given that each division may have

information that can be of value to another. However, because of the profit centre concept, each product line operates independently, and communication and cooperation are downplayed, if not discouraged.

Global area structure

A **global area structure** is a polycentric (host country-oriented) structure in which primary operational responsibility is delegated to area managers, each of whom is responsible for a specific geographic region. Figure 9.5 provides an example. Every regional division takes responsibility for all functions in its area – production, marketing, personnel and finance. There appears to be some structural similarity between a global area and a global product arrangement; however, they operate in very different ways. With a global product arrangement, each product division is responsible for its output throughout the world. With a global area structure, on the other hand, the individual product lines are subsumed within each of the geographic areas. So the manager in charge of Belgian operations, for example, will be responsible for each of the product lines sold in that region.

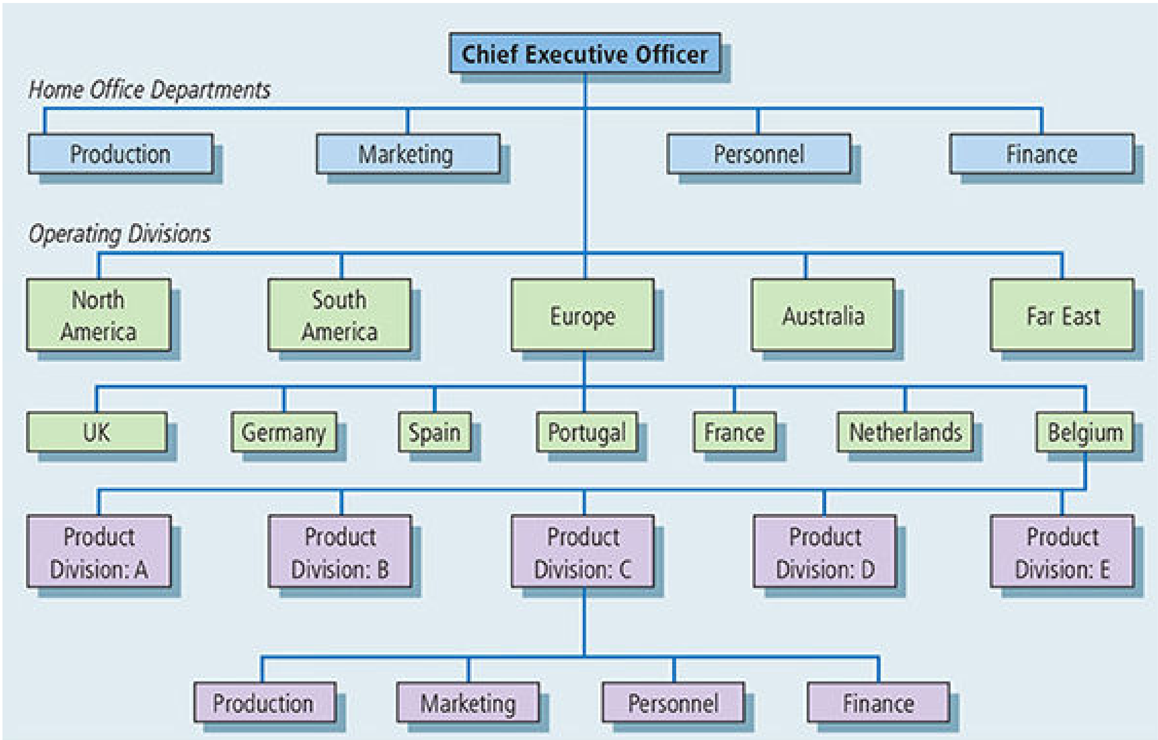

Figure 9.5 A global area structure

A global area structure is commonly used by MNEs that are in mature businesses and have narrow product lines that are differentiated by geographic area. Food products are a good example.

The global area structure provides division managers with the autonomy to make rapid decisions that depend on local tastes and regulations; because of this, the firm can become more 'nationally responsive'. Also, the company gains a wealth of experience in how to satisfy these local tastes, often building a strong competitive advantage in the process. The global area structure works well when economies of scale in production require a region-sized unit for basic production. For example, by setting up operations in the EU, a US company is able to achieve production cost advantages that would not otherwise be possible. Finally, the company can eliminate costly transportation associated with importing goods produced overseas.

If a product sells well in the United States, the company is likely to try to market it worldwide without making any modifications for local taste. Under

the area structure, the opposite viewpoint holds: the product must be adapted to local tastes. But this means that the usual product emphasis in a company must be subsumed to the company's geographic orientation and the authority of the area managers. Another shortcoming with this organisation structure is the expense associated with duplicating facilities. Each division has its own functional areas and is responsible for both production and marketing. Because production efficiency is often based on the amount of output, small plants are usually less efficient than large ones. Companies using a global area division structure also find it difficult to coordinate geographically dispersed divisions into the overall strategic plan. Quite often international cooperation and synergy among divisions end up being sacrificed. Finally, companies that rely heavily on R&D to develop new products often find that the global area divisions do not readily accept these offerings. This is because each group is trying to cater to the specific needs of its current market, and new products often require modification to meet those needs. Research shows that division managers prefer to sell products that have already been accepted by the market and are reluctant to take on new, untried products.

Global functional structure

A **global functional structure** is one built around the basic tasks of the organisation. For example, in manufacturing firms, production, marketing and finance are the three primary functions that must be carried out for the enterprise to survive. Figure 9.6 shows such an arrangement. The head of the production department is responsible for all domestic and international manufacturing. Similarly, the head of marketing is responsible for the sales of all products here and abroad. This structure is most commonly used by MNEs with a narrow product line that has reached a stable plateau of global coverage and a level of demand that does not face major changes in a competitive attack.

The advantages of the global functional structure are allowing a small group of managers to maintain control over a wide-reaching organisation, little duplication of facilities, and tight, centralised control. One disadvantage is difficulty in coordinating the production and marketing areas, since each operates independently of the other. This can be particularly troublesome if the MNE has multiple product lines. A second disadvantage is that responsibility for profits rests primarily with the CEO because there is little diffusion of operating authority far down the line. Researchers have found that the global functional arrangement is most common among raw materials extractors with heavy capital investment. Energy firms also use it. However, this is not a structure that suits many other kinds of businesses.

Matrix structure

A **matrix structure** is an organisational arrangement that blends two organisational responsibilities, such as functional and product structures, or regional and product structures. The functional emphasis focuses on the activities to be performed, whereas the product emphasis focuses on the good that is being produced. This structure is characterised by a dual command system that emphasises both inputs (functions) and outputs (products), thereby facilitating development of a globally oriented management attitude. Figure 9.7 illustrates a product–region matrix.

There are three types of managers in this geocentric matrix structure: regional managers, product managers and matrix managers. **Regional managers** are charged with business in their markets. Their operation budgets include selling any of the products made by the MNE, subject to the decision of each regional manager. Their focus is polycentric. **Product managers** are responsible for coordinating the efforts of their people in such a way as to ensure the profitability of a particular business or product line. Their attitude

is ethnocentric. The matrix managers are responsible to *both* regional *and* product managers – they have two bosses.

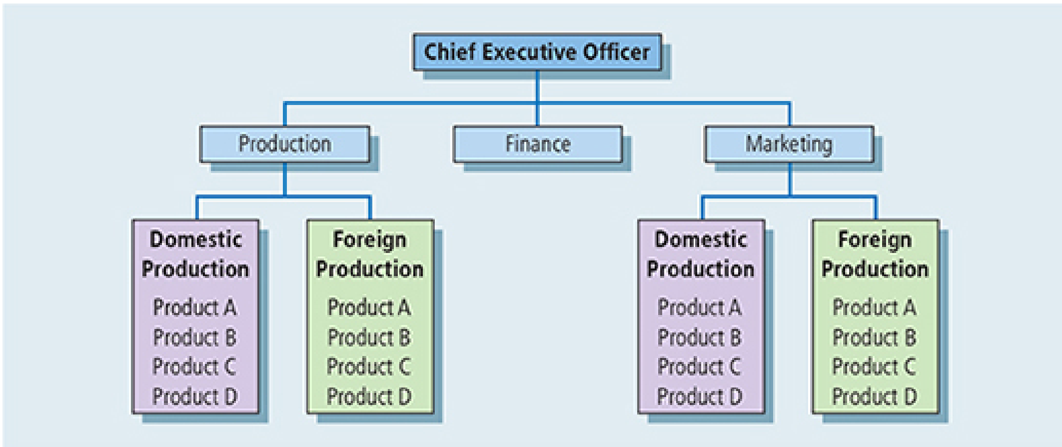

Figure 9.6 A global functional structure

Regions / Products	Country A	Country B	Country C
Product 1			
Product 2			
Product 3			

Figure 9.7 A geographic matrix structure

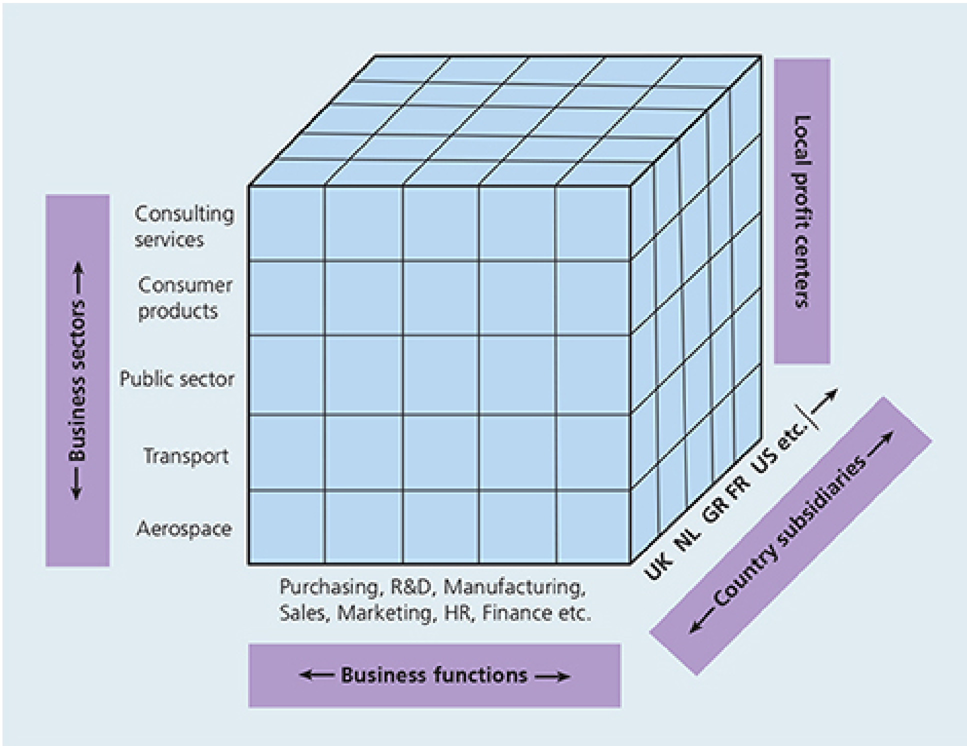

Figure 9.8 **A multinational matrix structure**

With its three dimensions, the matrix design in Figure 9.8 is more complex than that in Figure 9.7. It illustrates how the matrix organisational arrangement can be used to coordinate and manage wide-reaching international operations. **Resource managers** are charged with providing the people for operations, whereas **business managers** are responsible for coordinating the efforts of these people to make profits for the product line. The resource managers are concerned with inputs, business managers with outputs. The bottom of Figure 9.8 shows functional specialists from such areas as marketing, manufacturing and research. Individuals from each of these areas are assigned to each of the company's nine businesses. In turn, these nine profit centres operate in five different areas of the world, including the United States, Europe and Asia. Each business is run by a business board (not shown in the figure) that reports to senior-level management.

The matrix design in Figure 9.8 is sometimes referred to as a three-dimensional model because when it is drawn it has width, height and depth.

This multidimensional matrix addresses three major areas: function, product and geography. So the structure is really a combination of some of the designs discussed earlier.

INTERNATIONAL BUSINESS STRATEGY IN ACTION

Baker Tilly changes its name to RSM

Baker Tilly LLP, the UK-based subsidiary of Baker Tilly International, was a provider of audit, tax and consulting services to middle market clients. With 130 partners, revenues reached approximately $330 million in 2014. In 2014, the firm acquired RSM Tenon at a cost of estimated $40 million after it had entered into administration following a period of financial volatility since 2011. This led to Baker Tilly LLP becoming the largest member of the Baker Tilly International group. Baker Tilly International generated a combined revenue of $3.6 billion in 2014 from 154 member firms in 133 countries, which employed over 27,000 individuals. Importantly, the incorporation of RSM Tenon into Baker Tilly was not designed to increase the breadth of services that could be offered to clients. Rather, given that RSM Tenon was of a comparable size to Baker Tilly, the acquisition, which increased headcount to 3,500 employees, enabled Baker Tilly to strengthen its competitive position within the marketplace and consolidate the mid-tier accounting industry.

Despite Baker Tilly having acquired RSM Tenon, after a year of trading as a combined entity under the Baker Tilly International umbrella, Baker Tilly LLP decided to withdraw from the network and realign themselves with RSM International. In doing so, Baker Tilly LLP changed its name and began trading as RSM in the UK in 2015. RSM International's position within the top ten global accounting networks, as well as being one of the fastest growing ones having achieved an 18 per cent revenue increase in 2014, was evidently attractive to the UK organisation. RSM International was also significantly larger than Baker Tilly International, with approximately 37,500 staff in 730 offices in over 110 countries worldwide. Thus, rather than just switching to a new international network, the UK name change signalled the firm's commitment to its new identity to the market. It also enhanced the synergies it could gain from the international network through increased brand recognition.

Initially, Baker Tilly decided to roll out the new RSM logo followed with the phrase 'The power of being understood' in each of their 35 locations. Although all member firms operate under RSM, fundamentally they are individual legal entities within the network. Jean Stephens, who has been at RSM International for over 20 years and was appointed as CEO in 2006, stated that uniting members

under one single brand was important for their long-term growth strategy. This was because it enabled RSM to promote their resources and expertise, and provide an enhanced, seamless service offering to clients all over the world. In conjunction with this, the newly rebranded RSM, launched a new website, rsmuk.com, and changed its Twitter handle to @rsmuk.

RSM's UK Managing Partner, Laurence Longe, asserted that the bold decision to change their brand presented an opportunity for RSM to position themselves as the first-choice adviser to middle market leaders. Not only was the firm able to draw on local knowledge from the UK, but they were able to exploit the global expertise from the RSM International network. Before the decision was made to rebrand, former UK Baker Tilly concluded that RSM International was actually more closely aligned with Baker Tilly's clients' needs and international growth aspirations when compared to Baker Tilly International. Finally, a key reason to align with RSM International concerned RSM's strength in the US; although RSM International only had one American firm in its network, McGladrey, it is the fifth largest firm in the world, compared to Baker Tilly International which had a more fragmented presence in this key market with 13 different member firms.

The Baker Tilly name operated in the UK for 27 years from 1988–2015, until the rebrand as RSM. The adoption of the name of the acquired firm, by the acquirer, which is not usual practice, was a bold move on the face of it, but provided the opportunity to benefit from synergies of the RSM International network through stronger global linkages, especially in the US. This signalled the value to be gained from rebranding in this way, and paved the way for RSM (both nationally and internationally) to bring clarity, continuity and consistency to its long-term strategy.

Source: https://www.accountancydaily.co/baker-tilly-name-dropped-firm-rebrands-rsm-uk; https://www.rsmuk.com/news/baker-tilly-and-rsm-tenon-merge; https://economia.icaew.com/news/october-2015/rsm-launches-global-rebrand.

One of the major advantages of the multinational matrix is that it allows management to address more than one primary area of consideration. As Figure 9.8 shows, the company is able to focus on functional, product and geographic considerations. MNEs that need to balance a product and a global location strategy can benefit from this type of structure.

A drawback to the use of the matrix structure in international operations is the complexity of the design and the use of dual command, which can result in confusion about what everyone is responsible for doing and to whom one reports on various matters. A second drawback is the large number of meetings and discussions that often result from efforts to coordinate a variety of different groups, each with its own agenda. A third is that it often takes time for managers to learn to operate in a matrix structure, and if the enterprise has rapid turnover, there is always a significant portion of the personnel who do not fully understand how to function effectively in this environment.

Mixed structure

A **mixed structure** is a hybrid organisation design that combines structural arrangements in a way that best meets an enterprise's individual needs. Figure 9.9 provides an illustration. While pedagogically it is important to look at the models illustrated above, in practice a pure function, product or area structure hardly ever exists. Most firms have some sort of mixed structure. Different businesses with different patterns of global demand, supply and competition demand different management structures. Some structures might be very close to those mentioned above, but there is always some adaptation to be able to meet the needs of each specific enterprise.

Transnational network structure

One of the newest forms of international organisational arrangements to emerge is the **transnational network structure**, which is designed to help MNEs take advantage of global economies of scale while also being responsive to local customer demands. This structural design combines elements of functional, product and geographic designs, while relying on a network arrangement to link the various worldwide subsidiaries. At the centre

of the transnational network structure are nodes, which are units charged with coordinating product, functional and geographic information. Different product group units and geographical area units have different structures depending on what is best for their particular operation. A good example of how the transnational network structure works is provided by Philips NV, which has operations in more than 100 countries and produces a diverse product line ranging from light bulbs to defence systems. In 2018, the firm generated sales of $20 billion and employed approximately 77,000 employees. In all, the company has six product divisions with a varying number of subsidiaries in each – and the focus of the latter varies considerably. Some specialise in manufacturing, others in sales; some are closely controlled by headquarters, others are highly autonomous.

The basic structural framework of the transnational network consists of three components: dispersed subunits, specialised operations and interdependent relationships. *Dispersed subunits* are subsidiaries that are located anywhere in the world where they can benefit the organisation. Some are designed to take advantage of low factor costs, whereas others are responsible for providing information on new technologies or consumer trends. *Specialised operations* are activities carried out by subunits that focus on particular product lines, research areas and marketing areas, and are designed to tap specialised expertise or other resources in the company's worldwide subsidiaries. *Interdependent relationships* are used to share information and resources throughout the dispersed and specialised subunits.

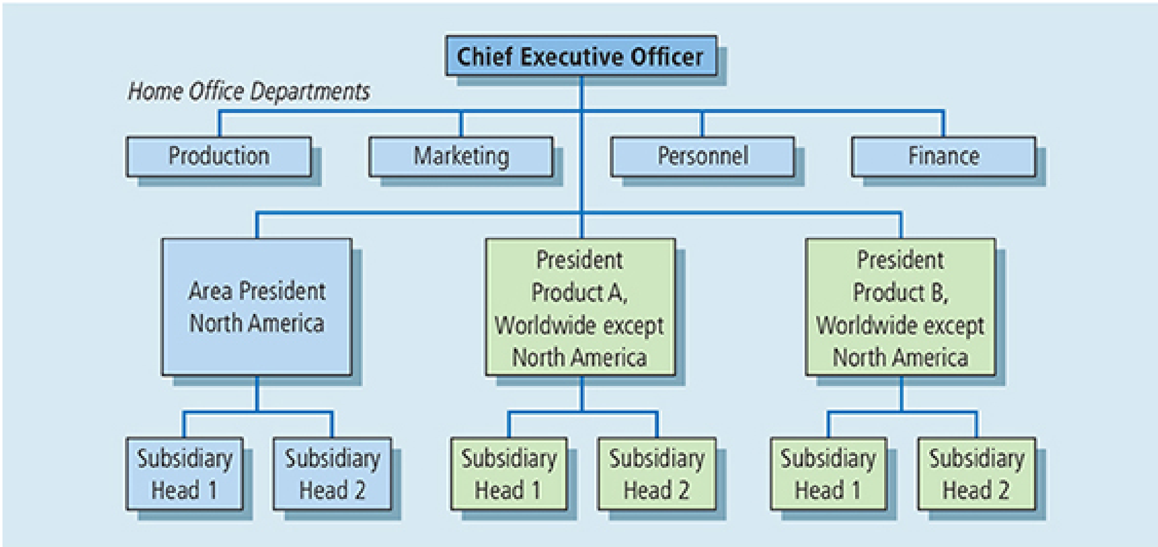

Figure 9.9 **A mixed structure**

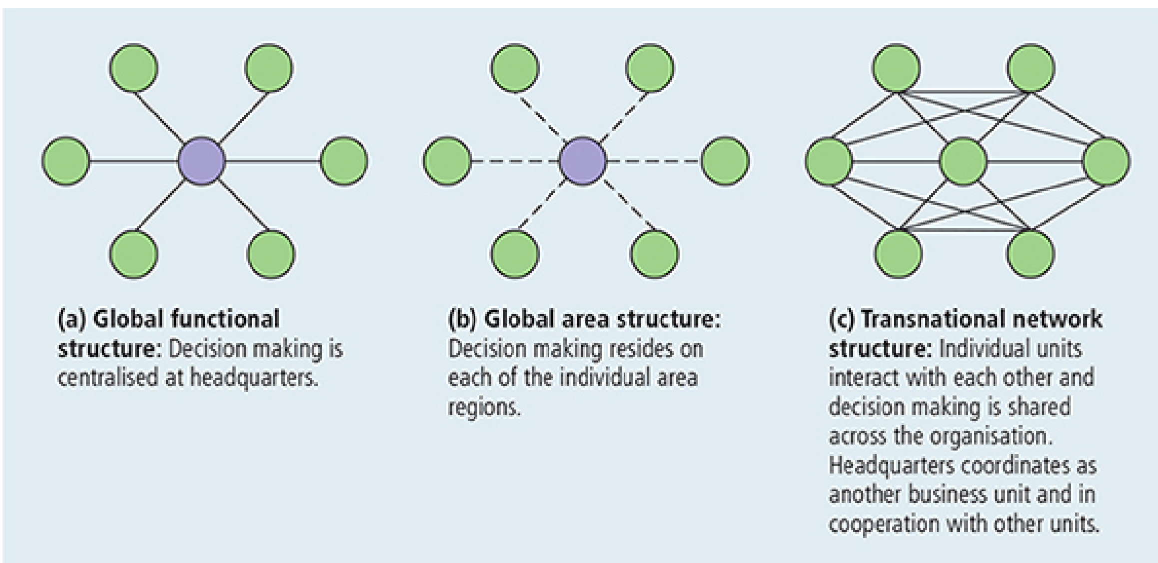

Figure 9.10 **A transnational network structure**

The transnational network structure is difficult to draw in the form of an organisational chart because it is complex and continually changing. Figure 9.10 gives a graphic scheme for the structure in comparison to the functional and area structures. The functional structure is one in which all decision making is made at headquarters, which coordinates all operations. The area or geographic structure, is one in which each subunit acts independently from the others. That is, decision making is totally decentralised. The transnational

network structure is a combination of both. Individual units interact with each other and decision making is shared across the organisation.

Active learning check

Review your answer to Active Learning Case question 1 and make any changes you like. Then compare your answer to the one below.

1 What type of organisation structure does P&G have in place for its worldwide operations? Is this structure optimal?

P&G follows a three-axis matrix structure in which the organisational responsibilities are divided among (a) regional marketing, (b) product-based R&D and manufacturing, and (c) regional logistics. These, in turn, are overseen by the Corporate Functions department. Because of the scale and international reach of its operations, a matrix structure allows high levels of national responsiveness in the marketing of P&G's branded products, economies of scale in R&D and production to be materialised through the Global Business Units, and economies of scale in logistics through the Global Business Services. Other types of organisation structures would either constrain national responsiveness in marketing or undermine the company's capacity to achieve economies of scale at a regional level.

STRATEGIC MANAGEMENT AND ORGANISING STRATEGY

Research has shown that effective organisations follow the adage 'From strategy to structure'.[3] They begin by formulating a strategy and only then design a structure that will efficiently implement this plan. Earlier in this chapter and elsewhere in this book we have referred to the decision tree for firms that are internationalising (see Figure 2 in the section 'Frameworks for this Book'). The interaction and frequent tension between structure and strategy has to be resolved every time an enterprise changes the international distribution of its assets, resources, employees or sales. In determining the best structure, three questions must be answered:

1. Can the company operate efficiently with domestic divisions or are international divisions also necessary?
2. On what basis should the organisation be structured: product, area, function, mixed or matrix?
3. How can the necessary coordination and cooperation be most effectively achieved?

These answers are usually determined through a careful analysis of five key variables.

Analysis of key structural variables

There are five key variables that MNEs examine in choosing from among alternative organisation structures. In some cases one of these variables will outweigh the others, and the structure will be designed to accommodate this

one. In most cases, however, there are three or four interacting variables that the structure must address.

First, the MNE will evaluate the relative importance of international operations at the current time and also look ahead to what this might be within three to five years. If the company is currently doing 5 per cent of its business overseas and has an export department handling these sales, this organisation structure may be adequate for now. However, if the MNE estimates that international sales will grow to 25 per cent of total revenues in five years, the company will want to consider adopting an international division structure or one of the global arrangements. Unless the firm is prepared to make this transition, it may prove difficult to handle the anticipated rapid growth.

Second, the company will take into account its past history and experience in the international arena. If the firm has done very little business abroad, it is likely to choose a simple structure that is easy to understand and control. If the company has been doing business overseas for many years, it will probably have experienced managers who can work well in a more sophisticated structure, so it may choose a mixed design or a matrix.

A third area of consideration is the company's business and product strategy. If the company offers a small number of products and there is little need to adapt them to local tastes, a global functional structure may be the best choice. On the other hand, if the products must be tailored for local markets, a global product arrangement will usually be more effective. If the company is going to be doing business in a number of diverse geographic areas, a global area structure will typically be used. For example, to improve sales growth in Europe and Asia, Coca-Cola reinforced its global area organisational arrangement by putting new managers into positions overseeing operations in these regions.[4]

A fourth influencing variable is the management's operating philosophy. If the company wants to expand rapidly and is prepared to take risks, the firm

will choose a structure that is quite different from that used by an MNE that wants to expand slowly and is conservative in its risk taking. Similarly, if the home office wants to keep a tight rein on operations, it will not use the same structure as a firm that gives local subsidiaries autonomy and encourages them to make decisions about how to keep the unit competitive at the local level. French and German subsidiaries, for example, tend to be more centralised than US units. There are also differences in the way operations are controlled. For example, Japanese MNEs like to use face-to-face informal controls, whereas US multinationals prefer budgets, financial data and other formalised tools.

A final key variable is the enterprise's ability to adjust to organisational changes. As MNE world sales increase, there are continual modifications in the structure. For example, when the company is small, the domestic divisions dominate. As the international side of operations grows, the managers of the domestic divisions have to cede some of their authority and influence. If they are unable or unwilling to do this, the structure is affected. Similarly, if international executives begin gaining greater authority and there is a need to revamp overseas operations, their willingness to adjust to organisational changes will affect the structure. In some cases MNEs have found that overseas managers, just like their domestic counterparts, build small empires and often are unwilling to give up this power.

The ultimate choice of organisation structure rests with top management. However, this group seldom tries to force such a decision on those who will be directly affected. Instead, there is a give-and-take in which the needs of the enterprise and the personnel are considered.

In recent years, the increase in mergers and acquisitions (M&A) has had an important impact on MNE decision making. Deutsche Telekom's T-Mobile International provides a good example. As of 2017 the organisation generated $40.7 billion in revenue and had 44,000 employees. The firm had an

ownership position in a large number of cell phone companies in a host of different countries (Austria, Croatia, Czech Republic, Albania, Germany, Hungary, Macedonia, Montenegro, the Netherlands, Poland, Romania Slovakia, the UK, the United States and Puerto Rico), including VoiceStream (US), One2One (UK), Ben (Netherlands), max.mobil (Austria), and Radio Mobil (Czech Republic). Most of this expansion has taken place through M&As and coordinating the operations of these holdings requires a carefully designed structure coupled with the appropriate amount of decentralised authority. Managers also need to proactively adapt the organisational processes for resource-allocation, coordination, communication and incentivising staff within the structure.

✔ Active learning check

Review your answer to Active Learning Case question 2 and make any changes you like. Then compare your answer to the one below.

2 Why was the international division replaced by the matrix structure?

The international division is a fairly primitive type of organisation structure of an MNE. It is used at an early stage of international expansion (by P&G in the 1940s and 1950s). As P&G's sales in the international market increased beyond 20 per cent or so, it turned to a more complex global organisation structure, the three-axis global matrix, with which it could be nationally responsive and achieve economies of scale.

Table 9.2 Factors that encourage centralisation or decentralisation of decision making in multinational operations

Encourage centralisation of decision making	Encourage decentralisation of decision making
Large enterprise	Small enterprise
Large capital investment	Small capital investment
Relative importance of the unit to the MNE	Relative unimportance of the unit to the MNE
Highly competitive environment	Stable environment
Strong volume-to-unit-cost relationship	Weak volume-to-unit-cost relationship
High degree of technology	Moderate to low degree of technology
Low level of product diversification	High level of product diversification
Homogeneous product lines	Heterogeneous product lines
High interdependence between the units	Low interdependence between the units
Few highly competent managers in the host country	Many highly competent managers in the host country
High experience in international business	Low experience in international business
Small geographic distance between home office and subsidiary	Large geographic distance between home office and subsidiary

Coordination

The formal structure provides the skeletal framework within which the personnel operate. The structure is designed to answer the question: what is to be done? The organisational processes – decision making, communicating and controlling – help make the structure work efficiently. These processes help answer the questions: who should do what, and how will they do it? These processes help put the organisation structure into action.

Decision making

Decision making is the process of choosing from among alternatives. In international operations one of the primary areas of consideration is where the ultimate decision-making authority will rest on important matters. If the home office holds this control, decision making is centralised; if the subsidiary can make many of these important decisions without having to consult the home office, decision making is decentralised. Table 9.2 provides some examples of factors that encourage both these types of decision making.

Research shows that decision making in MNE subsidiaries tends to vary from country to country or culture to culture. For example, British organisations are said to have more decentralised decision making, while French and German subsidiaries tend to be fairly centralised in their decision-making approaches. But these can be unhelpful stereotypes; there is likely to be as much or more variation between British firms as there is between British, French and German firms. Chapter 5 on international culture explores these differences, linking cultural factors to organisational styles.

✔ Active learning check

Review your answer to Active Learning Case question 3 and make any changes you like. Then compare your answer to the one below.

3 Why does the company rely on decentralised decision making?

The primary reason why the firm relies so heavily on decentralised decision making is because the demands of the local areas are so great that it cannot make all important decisions from headquarters. This applies to the SMOs (previously MDOs), which must market to different cultures with different languages and business environments. But it also applies to the GBSs catering directly to a given region, which must function in the relevant languages and understand regionally specific logistics environments. Decision making is also delegated to the GBUs, which specialise to provide the most efficiency and innovation in each product category and to dissipate R&D knowledge across product families.

Communication

Communication is the process of transferring meanings from sender to receiver. However, the way of doing this often varies from one MNE to another. For example, US MNEs tend to use direct communications with their subsidiaries and overseas units. Directives are spelled out clearly and precisely and contractual terms are used to control actions. Meanwhile, Japanese MNEs prefer more indirect communications in which things are implied and it is up to the listener to determine what to do. The direct approach works well for Americans, whose culture encourages openness and specific communications. The indirect approach works well for the Japanese, whose culture encourages indirect and implied communications. Again, Chapter 5 provides more detail and examples of the business challenges created by cultural differences.

Another communication-based problem is non-verbal messages. In international business these take two major forms: kinesics and proxemics. **Kinesics** deals with the conveying of information through the use of body movement and facial expression. For example, when verbally communicating with someone in the United States, it is good manners to look the other party in the eye. However, in many other cultures, such as the Arabic and Middle Eastern, this is not done, especially if one is talking to a member of the opposite sex. Such behaviour would be considered rude and disrespectful.

Proxemics deals with how people use physical space to convey messages. For example, in the United States, business people typically stand 2 to 3 feet (75 cm) away from those with whom they are communicating. However, in the Middle East and in many South American countries it is common to stand right next to the person. This often makes Americans feel very uncomfortable because this space is generally reserved only for family members and close friends. Business is not conducted at this distance.

Another example of proxemics is office layout and protocol. In the United States, a large office connotes importance, as does a secretary who screens visitors and keeps away those whom the manager does not wish to see. In Japan, most managers do not have large offices; if they do, they spend little time in them since they are generally out talking to the employees and walking around the workplace. If the manager were to stay in the office all day, it would be viewed as a sign of distrust or anger at the work group. In Europe, many managers do not have walled-in offices, open-plan offices or temporary desking is said to be more common.

Every country has some unique communication patterns or behaviours. These behaviours can be particularly troublesome to outsiders who are working locally and are unfamiliar with local approaches to communication. Figure 9.11 provides an interesting example in the form of epigrams that have been drawn from organisation structures throughout the world.

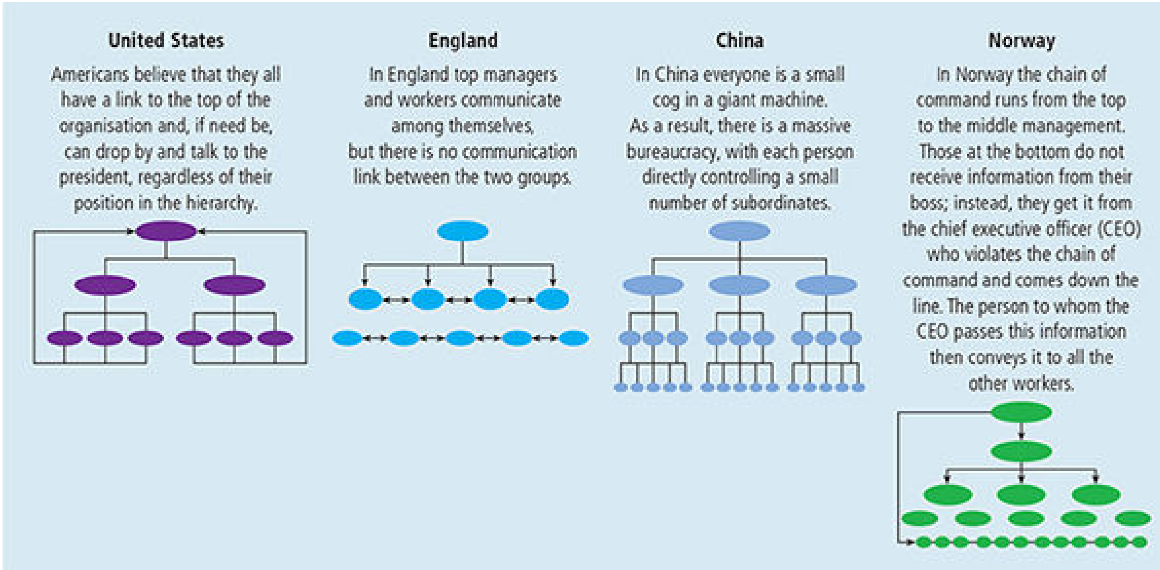

Figure 9.11 Organisational epigrams

Source: Adapted from Simcha Ronen (1986), Comparative and Multinational Management, John Wiley & Sons, Inc.

Controlling

Controlling is the process of determining that everything goes according to plan and that performance is rewarded. It consists of three steps: (1) establishing standards; (2) comparing performance against standards; and (3) correcting deviations. Controlling is closely linked to communication since it is virtually impossible to evaluate performance and make changes without communicating information. Many of the same organisational problems discussed above also apply here.

In looking at differences between firms from different countries there are some general patterns. US managers tend to use explicit control mechanisms, financial bonuses and sanctions whereas the Japanese tend to rely on implicit control, social pressure and team-based rituals. Some firms rely on reports and 'transactional' control mechanisms, for example using targets and performance data to apply rewards via formal personal review processes. Others tend towards behavioural or social and hierarchical mechanisms, or

may focus on team recognition and rewards. These differences in approaches and mechanisms to control greatly affect the way the organisational structures are managed and evolve. The effectiveness and efficiency of international M&As, joint-ventures and even supplier–buyer contracting relationships are strongly influenced by these differences.

Active learning check

Review your answer to Active Learning Case question 4 and make any changes you like. Then compare your answer to the one below.

4 In controlling its operations, what are three areas that are paramount for the firm?

There are a number of areas P&G needs to control. One of these is profit. The company must ensure that its divisions are profitable in each market in which it operates. A second area is cost control. Presently, P&G's matrix structure is designed to be nationally responsive and decreases costs through economies of scale. A third area is innovation. One of the firm's principal competitive advantages is its ability to improve its brands against the competition; as a result, it must weigh its advances in R&D against that of the competition. A fourth area of control is the brand awareness of consumers for P&G's brands.

KEY POINTS

1 When a company first enters the international arena, it is common to find that these efforts are mere extensions of domestic operations. The MNE will typically handle foreign sales directly through its own marketing department, an export department or an overseas subsidiary that is the result of a joint venture. As international operations become more important, however, the firm is likely to centralise these operations by adopting an international division structure. This organisational arrangement remains quite popular with many MNEs.

2 As multinationals generate increased revenues from their overseas operations, they are likely to adopt a global organisation structure. There are six basic types: global product; global area; global functional; mixed; matrix; and transnational network. Each type has specific advantages and disadvantages.

3 There are five key variables that MNEs examine in choosing from among alternative organisation structures: (a) the relative importance of international operations; (b) past history and experience in the international arena; (c) the company's business and product strategy; (d) management philosophy; and (e) the firm's ability to adjust to organisational changes.

4 The formal structure provides the skeletal framework within which the personnel operate. The organisation processes of decision making, communicating and controlling make the structure work efficiently. In the decision-making process, one of the key areas of consideration is the amount of centralisation or decentralisation that will be used by the home office. In communicating, culturally based differences will be of

major importance, including non-verbal messages. In controlling, areas of concern include explicit and implicit control and the ways in which personnel will be evaluated.

Key terms

- **international division structure**
- **global product structure**
- **global area structure**
- **global functional structure**
- **matrix structure**
- **regional managers**
- **product managers**
- **resource managers**
- **business managers**
- **mixed structure**
- **transnational network structure**
- **decision making**
- **communication**
- **kinesics**
- **proxemics**
- **controlling**

REVIEW AND DISCUSSION QUESTIONS

1 How does an export department structure function? Who handles the overseas sales?

2 If a company's initial international expansion is conducted through the use of subsidiaries, how closely does it control these subsidiaries? Why?

3 Why do MNEs use an international division structure? Are there any drawbacks to this organisational arrangement?

4 How does a global product structure work? Why would an MNE opt for this arrangement? What are two drawbacks to using this structure?

5 When would an MNE use a global area structure? When would the firm reject this structural arrangement in favour of a different structure?

6 How does a global functional structure work? When would it be a popular approach? When would it be of very little value in organising international operations?

7 When would a company opt for a mixed structure? Why? Defend your answer.

8 How does a matrix structure work? When would an MNE opt for this organisational arrangement?

9 There are five key variables that MNEs examine in choosing from among alternative organisation structures. What are these five? Identify and briefly describe each.

10 Why are some overseas operations highly decentralised while others are very centralised? What factors influence this arrangement?

11 Why are US international operations more centralised than those in Sweden? Why is the US model becoming more popular among MNEs?

12 In what way is implicit versus explicit communication important in understanding how home-office managements coordinate international activities?

13 What type of control techniques do US MNEs prefer? How does this preference differ from that of the Japanese? Compare and contrast the two.

REAL CASE

LVMH: organising luxury products in the international arena

LVMH is the French-based, world-leading luxury goods group that was founded in 1987 with the merger of Louis Vuitton and Moët Hennessy. Christian Dior, Dom Pérignon, Givenchy and Moët & Chandon are just a few of LVMH's world-famous luxury brand names. By 2018, revenues for the group totalled approximately $53 billion, putting it among the top five marketers of luxury items (including wines). LVMH operates approximately 4,374 stores across the world and employs more than 150,000 people, where over 70 per cent of employees work outside France. As of 2018, the company generates the bulk of its sales in foreign markets; only 6 per cent of all revenues are earned in France. The United States is the company's single largest market, comprising 32 per cent of revenues. It is important to note that although France earns a small fraction of LVMH's revenues, Europe as a whole (including France) accounts for 25 per cent. Japan accounts for 6 per cent, while Asia (excluding Japan) accounts for 23 per cent. The remaining 14 per cent is generated mainly in the Pacific, Latin America, and Canada. With large shares of sales in each broad region of the triad, LVMH is a true global company.

LVMH's organisational structure is much more than that of a typical conglomerate. The whole organisation focuses on shared costs and synergies, both backward and forward in its value chain. The five main lines of business are really strategic business units (SBUs) that are set up to market well-known, high-quality products while responding to local tastes and regulations. They are: (1) 'Fashion & Leather Goods'; (2) 'Wines & Spirits'; (3) 'Perfumes & Cosmetics'; (4) 'Watches & Jewelry'; and (5) 'Selective Retailing & Other'. Figure 9.12 illustrates the breakdown of revenue within each of these five business groups.

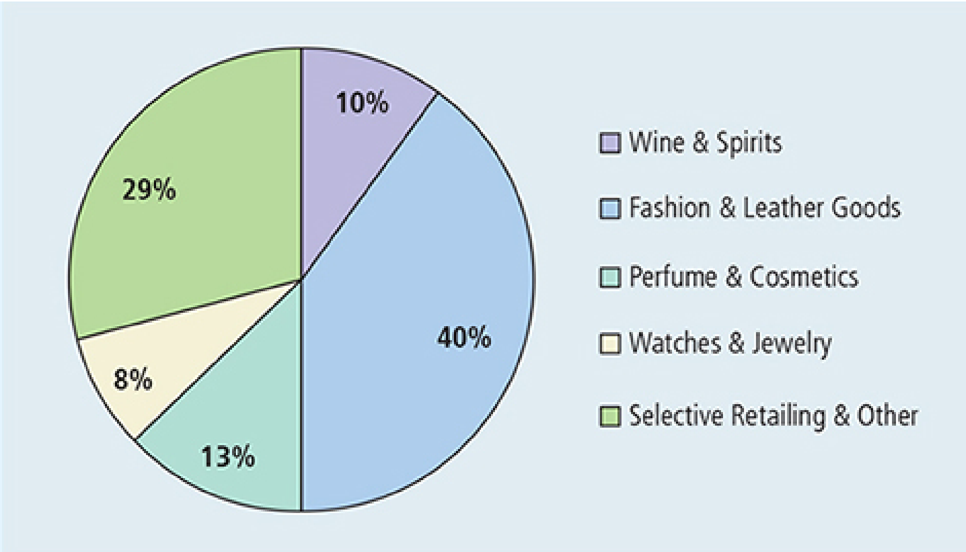

Figure 9.12 LVMH Revenue by Business Group, 2018

Source: www.lvmh.com.

By carefully overseeing major operations from the top while allowing the individual SBUs to make the decisions that directly affect their own local markets, LVMH employs a combination of 'tight and loose' control to maximise its international presence. In the process, it has become the most global retail company.

The profit margin on luxury goods is very high, so control over production, distribution and advertising is central to profitability. LVMH ensures that production standards in its manufacturing operations are the highest. It centralises manufacturing by using a common laboratory for cosmetics research and integrates the operations for all the branch offices in each group to ensure maximum efficiency.

Source: FORGET Patrick/SAGAPHOTO.COM/Alamy Stock Photo

Marketing is a very important part of LVMH's strategy. The company spends around 10 per cent of all its revenues on worldwide advertising and purchases media products in bulk to receive the best value for its money. The 'Made in France' label is stressed to appeal to its home country's reputation for high-quality luxury products. The company sources only in France, Italy and Switzerland.

The vision of a totally integrated group was and continues to be an important part of the global strategy that has positioned LVMH as an industry leader. The company walks a fine line between the exclusivity required of luxury goods and the size and scope of its operations. It might operate around the world, but its products are not accessible to all.

Websites: www.lvmh.com; www.vuitton.com; www.moet.com; www.dior.com; www.givenchy.com; https://www.lvmh.com/investors/profile/key-figures/#structure-financiere.

Sources: Adapted from www.lvmh.com; LVMH, *Annual Report*, 2010, 2014, 2018; Stéphane Girod and Alan M. Rugman, 'Regional business networks and the multinational retail sector', *Long Range Planning*, vol. 38, no. 4 (2005), pp. 335–57.

1 What type of organisation structure does LVMH have?

2 What is the role of the SBUs in the organisation structure of LVMH? What problems might arise if each SBU were run independently?

3 Compare the organisation structure of LVMH to that of Procter & Gamble. Are there any similarities? How are these organisations different?

4 What are some of LVMH's FSAs that are listed in this case?

5 How would outsourcing to less developed countries affect LVMH?

REAL CASE

Maersk Group

An example of the business-to-business (B2B) relational contracts found in the flagship model can be found in some of the operations of Maersk. This is the world's largest container-based shipping group. It has B2B relationships with companies that use its containers, with port authorities, and with suppliers of its energy resources.

A.P. Møller-Maersk (APM) is a Denmark-based shipping group with sales of $31 billion and assets of $63 billion in 2017. The group owns and operates container carriers, bulk carriers, supply and specialty ships, and tankers. The group also provides various services in the areas of energy, shipping and offshore, and retail. The A.P. Møller-Maersk Group comprises approximately 1,000 companies. The group owns and operates more than 500 container vessels with a total capacity of around 3 million TEU (Twenty-foot Equivalent Units). The main competitors to Maersk are shown in Table 9.3.

The Maersk Group divides its business into six segments: container shipping and related; tankers, offshore and related; terminals; oil and gas; retail and other; and technology. These are shown in Figure 9.13.

1 Container and related activities:

- Maersk Line
- Damco
- Maersk Container Industry
- Safmarine
- MCC Transport

2 Energy:

- Maersk Oil

3 Tankers and offshore-related activities:

- Maersk Tankers
- Maersk Drilling
- Maersk FPSOs

- Maersk Supply Services

4 Terminal activities:

- APM Terminals

5 Retail and related business (not discussed here):

- Dansk Supermarked
- Svitzer

6 Technology:

- Maersk Fluid Technology
- Maersk Maritime Technology

Maersk Line is one of the leading liner shipping companies in the world, serving customers all over the globe. The company also has nearly 800 vessels and operates across 100 countries. The Maersk Group provides similar container services across north/south trade lanes under the Safmarine name.

Maersk Logistics was combined with Damco in 2007 and no longer exists. Damco offers services such as inland haulage, customs house brokerage, and refrigerated services. The company also offers customised and integrated solutions for operations such as supply-chain management; warehousing and distribution; and ocean freight. The company primarily provides its services to the retail, electronics, fast-moving consumer goods and chemical industries.

Source: Peter Titmuss/Alamy Stock Photo

APM Terminals is one of the world's largest operators of container terminals with over 70 ports spanning 40 countries and five continents. APM Terminals had revenues of $4.1 billion in 2017. The company primarily engages in the development of port infrastructure necessary to meet the future demands of the global container trade. APM Terminals works closely with governments, country leaders, customers, truckers and the entire shipping community to ensure supply-chain efficiency and world-class service.

Maersk Container Industry produces various types of reefer containers for the transportation of goods through ship, rail or truck.

Maersk Oil operates the oil production of 550,00 barrels per day and more than 1,000 million cubic feet (28 million m^3) of gas production per day in the Danish and British parts of the North Sea, offshore Qatar, in Algeria, and in Kazakhstan. It conducts exploration activities in those areas as well as offshore Norway, the US Gulf of Mexico, Brazil, Angola and Oman.

Through Maersk Tankers, Maersk Contractors, and Maersk Supply Services the company offers solutions for the transport of crude oil, refined products and gas; various supply vessel activities (including anchor handling, platform supply and cable laying); drilling activities with mobile production units, and drilling rigs and ships, including advanced jack-up rigs, salvage and towage activities; and door-to-door transport and inter-European freight and passenger transport. Maersk Tankers owns and operates one of the world's largest and most modern fleets of crude, product and gas tankers. The fleet consists of more than 230 vessels.

Maersk Drilling (formerly known as Maersk Contractors) provides drilling and production services to oil companies. The company commands an extensive and technologically advanced fleet of some of the world's most advanced harsh environment jack-up rigs, 375ft and 350ft jack-up rigs, deep-water semi-submersibles, drilling barges, and workover barges.

Maersk Supply Services is primarily engaged in the field of tow-out and installation of large offshore installations, and other chartering services. The company maintains more than 50 offshore support vessels.

Examples of flagship partnerships

Maersk Line has flagship relationships. As explained above, it is one of the leading liner shipping companies. It operates nearly 800 container vessels and more than 3,000,000 containers. This

amounts to 11,363.63 miles (18,288 km) of containers. Although the Maersk organisation is extensively vertically integrated and produces vessels, containers and oil through subsidiaries, Maersk Line is highly dependent on its business networks. Mr. Søren Skou, the Partner Chief Executive Officer of Maersk Line Business, recognises the importance of partnerships, stating that 'communication and partnerships are as important as the physical movement of goods'.

Table 9.3 Top ten container shipping companies in order of TEU capacity, 2019

Company	TEU capacity*	Market share (%)	Number of ships
A.P. MØller-Maersk Group	40, 87,480	17.7	711
Mediterranean Shipping Company SA	3,308,955	14.5	517
China Ocean Shipping Company	2,79,2448	12.1	461
CMA CGM Group	26,43,745	11.6	505
Hapag-Lloyd	16,44, 565	7.1	231
Ocean Network Express	15,21,702	6.7	217
Evergreen Line	12,19406	5.2	203
Yang Ming Marine Transport	627,725	2.7	97
Hyundai Merchant Marine	424,724	1.8	72
Pacific International Line	420,039	1.8	128

*TEU capacity and market-share figures from: https://www.marineinsight.com/know-more/10-largest-container-shipping-companies-in-the-world/; https://www.championfreight.co.nz/top-ten-shipping-companies

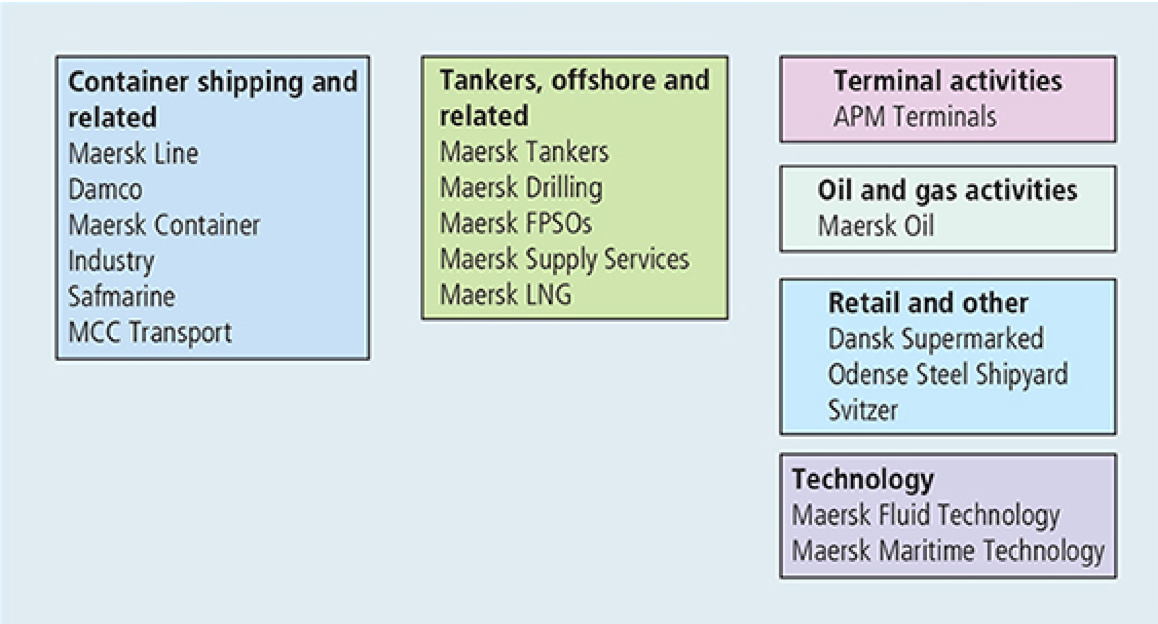

Figure 9.13 Segmentation of the Maersk Group activities

Maersk Line maintains a strategically critical relationship with its competitors. In the midst of flattening sales, the beginning of 2008 saw agreements between the top three largest container ship lines of Maersk Line, Mediterranean Shipping Co. and CMA CGM sharing vessel space on the trans-Pacific trade. Government relations are also critically important, the Maersk Group spends significant amounts of money lobbying the federal government on issues such as port safety, railroad regulations and ballast water legislation. The group is also a member of C–TPAT (Customs–Trade Partnership Against Terrorism), headed by the Department of Homeland Security. Maersk Line Limited, another Maersk Group subsidiary, transports more US government cargo related to military and humanitarian missions than any other company.

The Maersk organisation also maintains ties with research and educational institutions. In Denmark, Maersk is engaged in a corporate partnership with the Copenhagen Business School designed to provide real-world business applications and attract talent. Additionally, Maersk Line is also engaged in development projects such as that of an energy-saving cooling system involving Wageningen University, sponsored by the Dutch government. Other flagship relationships include:

- **IBM:** In 2005, IBM and Maersk Logistics joined forces to bring real-time, enhanced visibility to global supply-chain operations by improving the quality of container tracking and enabling

increased security of transported goods. The solution includes highly intelligent wireless tracking devices and an advanced technology network for use by manufacturers, retailers, logistics providers, carriers and governments to share real-time cargo information. Moreover, in 2018, Maersk and IBM launched a joint venture that connected all the supply chain participants around the world in one secure digital platform. Not only were both companies able to share and use information but they used this information to leverage the data to develop products for existing customers and the industry.

- **NVOCCs:** As Non-Vessel Operating Common Carriers, larger freight forwarders compete directly with Maersk Logistics but also have attractive contracts with Maersk Line and Safmarine. In fact, it is possible that leading forwarders such as Kuehne & Nagel and ABX Logistics have more attractive contracts than Maersk Logistics.
- **Mediterranean Shipping Company:** In 2018, Maersk and their closest competitor MSC, decided to combine forces so that they contribute, not only four of their operated loops, to a combined operation of five loops with ZIM between Asia end the U.S. East Coast. ZIM will operate one loop, Maersk Line and all parties will swap slots on all five loops of the new cooperation.

Websites: https://www.maersk.com/en/news/2018/06/29/maersk-and-ibm-launch-digital-joint-venture; http://www.themeditelegraph.com/en/shipping/shipowners/2018/07/23/maersk-partners-with-msc-zim-asia-east-coast-trade-q6pzb35ddOw5aVMndYrP9O/index.html

Sources: www.maersk.com/en; Maersk, *Annual Report*, 2009-17; 'Maersk spends $950,000 on lobbying', *Hellenic Shipping News*, 29 February 2008; analysis by authors of this book.

1 Who are the major competitors of Maersk?

2 To what extent and to whom does Maersk act as a key supplier?

2 What is the key competitive advantage (firm-specific advantage) of Maersk?

NOTES

1 See, for example, Yigang Pan and Xiaolian Li, ‘Joint venture formation of very large multinational firms’, *Journal of International Business Studies*, vol. 32, no. 1 (2000), pp. 179–89; and Tim G. Andrews and Nartnalin Chompusri, ‘Lessons in “cross-vergence”: restructuring the Thai subsidiary corporation’, *Journal of International Business Studies*, vol. 30, no. 3 (2000), pp. 77–93; and Namrata Malhotra and C. R. (Bob) Hinings, ‘An organizational model for understanding internationalization processes’, *Journal of International Business Studies*, vol. 41 (2010), pp. 330–49; doi:10.1057/jibs.2009.75.

2 For some excellent examples, see Charles H. Ferguson, ‘Computers and the coming of the US keiretsu’, *Harvard Business Review* (July/August 1990), pp. 55–70; and Benjamin Gomes-Casseres, ‘Joint ventures in the face of global competition’, *Sloan Management Review*, vol. 30, no. 3 (spring 1989), pp. 17–26.

3 Alfred D. Chandler, Jr., *Strategy and Structure* (Garden City, NY: Anchor Books, Doubleday, 1966).

4 Betsy McKay, ‘Coke reorganization puts three as contenders for no. 2 position’, *Wall Street Journal*, 31 July 2001, p. B2; and Louise Lucas in London, ‘Coca-Cola seeks cultural shift in Paris listing’, *Financial Times Online*, 23 May 2011; and Jonathan Birchall in New York, ‘Coca-Cola sees broad global growth’, *Financial Times Online*, 9 February 2011.

BIBLIOGRAPHY

Ambos, Björn and Mahnke, Volker. ‘How do MNC headquarters add value?’ *Management International Review*, vol. 50, no. 4 (August 2010).

Ambos, Björn, and Schlegelmilch, Bodo B. *The New Role of Regional Management* (Basingstoke: Palgrave Macmillan, 2010).

Ambos, Tina C. and Ambos, Björn. ‘Organizational capabilities and the effectiveness of knowledge flows within multinational corporations’, *Journal of International Management*, vol. 15, no. 1 (2009).

Ambos, Tina C. and Birkinshaw, Julian. ‘Headquarters’ attention and its effect on subsidiary performance’, *Management International Review*, vol. 50, no. 4 (August 2010).

Barkemeyer, Ralf, Preuss, Lutz and Lee, Lindsay. ‘On the effectiveness of private transnational governance regimes – evaluating corporate sustainability reporting according to the Global Reporting Initiative’, *Journal of World Business*, vol. 50, no. 2 (2015).

Barnard, Helena, and Cantwell, John. ‘Knowledge in the theory of the firm and MNC: asset or action? A commentary on Foss N. “Knowledge and organization in the theory of the MNC”’, *Journal of Management and Governance*, vol. 10, no. 1 (2006).

Bartlett, Christopher A. and Ghoshal, Sumantra. ‘Matrix management: not a structure, a frame of mind’, *Harvard Business Review*, vol. 68, no. 4 (July/August 1990).

Benito, Gabriel R. G., Grøgaard, Birgitte and Narula, Rajneesh. ‘Environmental influences on MNE subsidiary roles: economic integration and the Nordic countries’, *Journal of International Business Studies*, vol. 34, no. 5 (September 2003).

Bjorkman, Ingman, Barner-Rasmussen, Wilhelm and Li, Li. 'Managing knowledge transfer in MNCs: the impact of headquarters control mechanisms', *Journal of International Business Studies*, vol. 35, no. 5 (September 2004).

Bouquet, Cyril, Morrison, Allen J. and Birkinshaw, Julian M. 'International attention and multinational enterprise performance', *Journal of International Business Studies*, vol. 40, no. 1 (2009).

Buckley, Peter J. and Carter, Martin J. 'A formal analysis of knowledge combination in multinational enterprises', *Journal of International Business Studies*, vol. 35, no. 5 (September 2004).

Buckley, Peter J. and Strange, Roger. 'The governance of the multinational enterprise: insights from internalization theory', *Journal of Management Studies*, vol. 48, no. 2 (March 2011).

Cano-Kollmann, Marcelo, Cantwell, John, Hannigan, Thomas J., Mudambi, Ram and Song, Jaeyong. 'Knowledge connectivity: An agenda for innovation research in international business', *Journal of International Business Studies*, vol. 47, no. 3 (2016).

Ciabuschi, Francesco, Dellestrand, Henrik and Kappen, Philip. 'Exploring the effects of vertical and lateral mechanisms in international knowledge transfer projects', *Management International Review*, vol. 51, no. 2 (April 2011).

Ciabuschi, Francesco, Martín, Oscar and Ståhl, Benjamin. 'Headquarters' influence on knowledge transfer performance', *Management International Review*, vol. 50, no. 4 (August 2010).

Collinson, Simon and Morgan, Glenn. *Images of the Multinational Firm* (Oxford: Wiley-Blackwell, 2009).

De la Torre, José R., Esperança, José Paulo and Martínez, Jon I. 'Organizational responses to regional integration among MNEs in Latin America', *Management International Review*, vol. 51, no. 2 (April 2011).

Egelhoff, William G. ‘How the parent headquarters adds value to an MNC’, *Management International Review*, vol. 50, no. 4 (August 2010).

Figueira-de-Lemos, Francisco and Hadjikhani, Amjad. ‘Internationalization processes in stable and unstable market conditions: toward a model of commitment decisions in dynamic environments’, *Journal of World Business*, vol. 49, no. 3 (2014).

Foss, Nicolai J. ‘Knowledge and organization in the theory of the multinational corporation: some foundational issues’, *Journal of Management and Governance*, vol. 10, no. 1 (2006).

Foss, Nicolai J., Husted, Kenneth and Michailova, Snejina. ‘Governing knowledge sharing in organizations: levels of analysis, governance mechanisms, and research directions’, *Journal of Management Studies*, vol. 47, no. 3 (May 2010).

Ghoshal, Sumantra, and Bartlett, Christopher A. ‘The multinational corporation as an interorganizational network’, *Academy of Management Review*, vol. 15, no. 4 (October 1990).

Heracleous, Loizos. *Strategy and Organization* (Cambridge: Cambridge University Press, 2003).

Inkpen, Aandrew C. ‘Knowledge transfer and international joint ventures: the case of NUMMI and General Motors’, *Strategic Management Journal*, vol. 29 (2008).

Keupp, Marcus Matthias, Palmié, Maximilian and Gassmann, Oliver. ‘Achieving subsidiary integration in international innovation by managerial “tools”’, *Management International Review*, vol. 51, no. 2 (April 2011).

Kogut, Bruce, and Zander, Udo. ‘Knowledge of the firm and the evolutionary theory of the multinational corporation’, *Journal of International Business Studies*, vol. 24, no. 4 (1993).

Levy, Orly, Beechler, Schon, Taylor, Sully and Boyacigiller, Nakiye A. ‘What we talk about when we talk about “global mindset”: managerial cognition in multinational corporations’, *Journal of International Business Studies*, vol. 38, no. 2 (March 2007).

Li, Guey-Huey, Yu, Chwo-Ming and Seetoo, Dah-Hsian. ‘Toward a theory of regional organization’, *Management International Review*, vol. 50, no. 1 (February 2010).

Li, Jingxun and Lee, Ruby P. ‘Can knowledge transfer within MNCs hurt subsidiary performance? The role of subsidiary entrepreneurial culture and capabilities’, *Journal of World Business* (2014).

London, Ted and Hart, Stuart L. ‘Reinventing strategies for emerging markets: beyond the transnational model’, *Journal of International Business Studies*, vol. 35, no. 5 (September 2004).

Meyer, Klaus E. ‘Contextualizing organizational learning: Lyles and Salk in the context of their research’, *Journal of International Business Studies*, vol. 38, no. 1 (January 2007).

Minbaeva, Dana, Pedersen, Torben, Björkman, Ingmar, Fey, Carl F. and Park, Hyeon J. ‘MNC knowledge transfer, subsidiary absorptive capacity, and HRM’, *Journal of International Business Studies*, vol. 34, no. 6 (November 2003).

Mudambi, Ram and Navarra, Pietro. ‘Is knowledge power? Knowledge flows, subsidiary power and rent-seeking within MNCs’, *Journal of International Business Studies*, vol. 35, no. 5 (September 2004).

Oh, Chang Hoon and Li, Jing. ‘Commentary: Alan Rugman and the theory of the regional multinationals’, *Journal of World Business*, vol. 50, no. 4 (2015).

Parkhe, Arvind. ‘Interfirm diversity, organizational learning, and longevity in global strategic alliances’, *Journal of International Business Studies*, vol. 22, no. 4 (1991).

Piekkari, Rebecca, Nell, Phillip C. and Ghauri, Pervez N. 'Regional management as a system', *Management International Review*, vol. 50, no. 4 (August 2010).

Rosenzweig, Philip M. and Singh, Jitendra V. 'Organizational environments and the multinational enterprise', *Academy of Management Review*, vol. 16, no. 2 (April 1991).

Rugman, Alan M. and Verbeke, Alain. 'A note on the transnational solution and the transaction cost theory of multinational strategic management', *Journal of International Business Studies*, vol. 23, no. 4 (fall 1992).

Rugman, Alan M. and Verbeke, Alain. 'Extending the theory of the multinational enterprise: internalization and strategic management perspectives', *Journal of International Business Studies*, vol. 34, no. 2 (March 2003).

Rugman, Alan M. and Verbeke, Alain 'A regional solution to the strategy and structure of multinationals', *European Management Journal*, vol. 26 (2008).

Schotter, Andreas and Paul W. Beamish. 'Performance effects of MNC headquarters–subsidiary conflict and the role of boundary spanners: The case of headquarter initiative rejection', *Journal of International Management*, vol. 17, no. 3 (2011).

Segal-Horn, Susan and Dean, Alison. 'Delivering "effortless experience" across borders: Managing internal consistency in professional service firms', *Journal of World Business*, vol. 44, no. 1 (2009).

Sinkovics, Rudolf R., Roath, Anthony S. and Cavusgil, S. Tamer. 'International integration and coordination in MNEs', *Management International Review*, vol. 51, no. 2 (April 2011).

Steinbach, Adam L., Holcomb, Tim R., Holmes Jr, R. Michael Devers, Cynthia E. and Cannella Jr, Albert A. 'Top management team incentive heterogeneity, strategic investment behavior, and performance: A

contingency theory of incentive alignment', *Strategic Management Journal*, vol. 38, no. 8 (2017).

Tallman, Stephen and Chacar, Aya S. 'Knowledge accumulation and dissemination in MNEs: a practice-based framework', *Journal of Management Studies*, vol. 48, no. 2 (March 2011).

Tran, Yen, Mahnke, Volker and Ambos, Björn. 'The effect of quantity, quality and timing of headquarters-initiated knowledge flows on subsidiary performance', *Management International Review*, vol. 50, no. 4 (August 2010).

Verbeke, Alain. 'International acquisition success: social community and dominant logic dimensions', *Journal of International Business Studies*, vol. 41 (2010).

Verbeke, Alain and Kenworthy, Thomas P. 'Multidivisional versus metanational governance of the multinational enterprise', *Journal of International Business Studies*, vol. 39, no. 2 (2008).

Westney, Eleanor. 'Challenging the transnational model', *Socio-Economic Review*, vol. 12 (2008).

Westney, Eleanor D. and Zaheer, Srilata. 'The multinational enterprise as an organization.' In Alan M. Rugman (ed.), *The Oxford Handbook of International Business*, 2nd ed. (Oxford: Oxford University Press, 2009).

Wolf, Joachim and Egelhoff, William G. 'Limitations of the network organization in MNCs', in J. Pla-Barber and J. Alegre (eds.), *Progress in International Business Research*, vol. 5 (Amsterdam: Emerald, 2010).

Wolf, Joachim and Egelhoff, William G. 'Network or matrix? How information-processing theory can help MNCs answer this question.' In A. Bøllingtoft, L. Donaldson, G. P. Huber, D. Døjbak Håkonsson and C. C. Snow (eds.), *Collaborative Communities of Firms: Purpose, Process, and Design* (Springer Science, Business Media BV, 2011).

Chapter 10

CORPORATE STRATEGY AND NATIONAL COMPETITIVENESS

Contents

Objectives of the chapter

The primary objective of this chapter is to develop two frameworks for understanding how both nations and MNEs must fashion their strategies to achieve international competitiveness. In doing

so, we give particular consideration to the regional economic integration of North America, although these frameworks are also relevant for other triad economies and also for emerging economy firms.

The specific objectives of this chapter are to:

1. *Examine* the determinants and external variables in Porter's 'diamond' model of national competitiveness and critique and evaluate the model.
2. *Present* a 'double-diamond' model that illustrates how firms in non-triad countries such as Canada are using their diamond to design corporate strategies for the North American market.
3. *Discuss* the benefits and effects of the North American Free Trade Agreement on both Mexico and Canada.
4. *Describe* how Mexico is using a double-diamond model to tap into the North American market.
5. *Define* the terms *economic integration* and *national responsiveness* and relate their importance to MNE strategies throughout the world.

ACTIVE LEARNING CASE

Worldwide operations and local strategies of ABB

Headquartered in Zurich, Switzerland, Asea Brown Boveri (ABB) is one of Europe's major industrial firms. Since the merger in 1987 that created it, ABB has been acquiring or taking minority positions in a large number of companies throughout the world. In recent years it has purchased Westinghouse's transmission and distribution operations and Combustion Engineering, the manufacturer of power generation and process automation equipment.

ABB Ltd (ABB) provides power and automation technologies for its utility and industrial customers. It focuses on power transmission, distribution and power-plant automation, and serves electric, gas and water utilities, as well as industrial and commercial customers. ABB also delivers automation systems that measure, control, protect and optimise plant applications across a range of industries. By 2017, the conglomerate, which employs approximately 150,000 people worldwide, had annual revenues of $34.31 billion; 35 per cent of its revenues come from Europe, 29 per cent from the Americas and 36 per cent from Asia, the Middle East and Africa.

ABB operates on both local and global terms. On the one hand it attempts to maintain deep local roots wherever it operates so that it can modify both products and operations for that market. For example, managers are trained to adapt to cultural differences and to learn how to communicate effectively with local customers. At the same time the company works to be global and to make products that can be sold anywhere in the world because its technology and quality give it a worldwide appeal.

ABB has five distinctive business divisions: discrete automation and motion accounted for 24 per cent of total revenue in 2014, power products (also 24 per cent), low voltage products (18 per cent), process automation (18 per cent) and power systems (16 per cent).

This is possible for four reasons: (1) ABB's research and development makes it a leader in power and automation technology, enabling it to develop and build products and services throughout the world; (2) its operations are structured to take advantage of economies of scale and thus keep prices competitive; (3) it adapts to local environments and works closely with customers so that it is viewed

as a national rather than a foreign company; and (4) it works closely with companies in other countries that are favoured by their own government but need assistance in financing and producing equipment for that market. As a result, ABB is able to capitalise on its technological and manufacturing expertise and develop competitive advantages in both triad and non-triad markets.

In some cases ABB has gone so far as to take an ownership position in companies located in emerging economic markets. For example, the firm purchased 76 per cent of Zamech, Poland's leading manufacturer of steam turbines, transmission gears, marine equipment and metal castings. And it has bought into two other Polish firms that make a wide range of generating equipment and electric drives. ABB reorganised these firms into profit centres, transferring its own expertise to local operations and developing worldwide quality standards and controls for production. In Mexico, ABB acquired FIP SA in 2001, an oil and gas production equipment company. In October 2009, ABB Ltd. acquired Sinai Engineering Corporation to enhance its presence and capabilities in Western Canada. In January 2011, the company acquired Baldor Electric Company (the United States) at the value of $4.2 billion, including $1.1 billion of net debt.

In April 2015, the firm bought the small, Munich-based robotics firm, Gomtec GmbH. This makes sense when you know that ABB has installed more than 250,000 robots across the world. This merger and the large number of other acquisitions that have taken place throughout its history have to be fully incorporated into the ABB structure.

More recently, in 2019, ABB illustrated that they were not shy of divesting some of their business groups. For instance, ABB decided to sell the majority of their subsidiary ABB Ltd.'s power grid division to Hitachi, who manufacture communications and electronic equipment, heavy electrical and industrial machinery, and consumer electronics. More specifically, Hitachi agreed to acquire 80.1 per cent of this division for $6.4 billion, which is not bad considering that this division had a value including net debt of $11 billion.

Overall, ABB works hard to be a 'good citizen' of every country in which it operates, while also maintaining its supranational status. As a result, the company is proving that it is possible to have worldwide operations and local strategies that work harmoniously.

Website: www.abb.com; http://www.globallegalchronicle.com/hitachis-6-4-billion-acquisition-of-abbs-power-grids-business/

Sources: Adapted from William Taylor, 'The logic of global business: an interview with ABB's Percy Barnevik', *Harvard Business Review* (March/April 1991), pp. 91–105; Carol Kennedy, 'ABB: model merger for the new Europe', *Long Range Planning*, vol. 25, no. 5 (1992), pp. 10–17; Edward L. Andrews, 'ABB will cut 10,000 jobs and switch focus to Asia', *New York Times*, 22 October 1997, p. C2; Alan M. Rugman, *The Regional Multinationals* (Cambridge: Cambridge University Press, 2005); ABB, *Annual Report*, 2009, 2014; Thomson Reuters, *OneSource*, 2011; 'Fortune Global 500', *Fortune*, 2010. ABB website news, April 2015; Bossi Paolo 'Hitachi's $6.4 Billion Acquisition of ABB's Power Grids Business', *globallegalchroncile*, February 2019.

1. **In what way does ABB's strategy incorporate Porter's four country-specific determinants and two external variables?**
2. **Why did ABB buy Gomtec GmbH? How can the company link this small firm into its global strategy and structure?**
3. **How does ABB address the issues of globalisation and national responsiveness? In each case, cite an example.**

INTRODUCTION

In this chapter, two frameworks are developed. Again it is useful to relate these to the basic firm and country model first outlined in the opening chapters of this textbook. In this chapter we will first review the single-diamond model of Michael Porter (1990), which underpins a large amount of research and thinking about how firms and regions interact to create various competitive advantages. We will apply it to analyse the international competitiveness of large economies such as the United States, Japan and Germany. We then introduce the double-diamond framework which is more suitable for somewhat smaller but open trading economies, such as Canada, New Zealand, Korea, Singapore, and, indeed, most countries in the world. Both the Porter single diamond and the double diamond deal with CSAs. There are rankings of countries based on the manner in which their CSAs are being utilised to improve their international competitiveness. Yet, in this work on international competitiveness, the manner in which CSAs are turned into FSAs is often not made explicit.

The second framework outlined in this chapter is the famous economic integration and national responsiveness matrix. The economic integration axis is largely explained by CSAs. The national responsiveness axis is a pure FSA and is unique to international businesses. The managers of a multinational enterprise (MNE) have a network of overseas subsidiaries and national responsiveness is relevant when making decisions about the strategy and organisational structure of such firms. In contrast, purely domestic firms cannot experience FSAs in national responsiveness. Together, these two frameworks provide students with the basic insights necessary to analyse the

complex nature of the strategy and structure of multinational enterprises and other firms involved in international business.

Some MNEs rely on their home market to generate the research, development, design or manufacturing needed to sell their goods in international markets. More and more, however, they are finding that they must focus on the markets where they are doing business as well as on strategies for tapping the resources of those markets and gaining sales entry. In short, multinationals can no longer rely exclusively on the competitive advantage they hold at home to provide them with a sustainable advantage overseas.

In addition, many small countries realise they must rely on export strategies to ensure the growth of their economies. Those that have been most successful with this strategy have managed to tap into markets within triad countries. Good examples are Canada and Mexico, both of which have found the United States to be a lucrative market for exports and imports. As a result, many successful business firms in these two countries have integrated themselves into the US economy, while creating what some international economists call a North American market. In the future many more MNEs are going to be following this pattern of linking into the economies of triad members.

The basic strategy that these MNEs are following can be tied directly to the Porter model presented in earlier, although some significant modifications of this model are in order. We will first examine Porter's ideas in more detail and then show how these ideas are serving as the basis for developing corporate strategies and international competitiveness in Canada and Mexico.

THE SINGLE DIAMOND

At several points throughout this book we have referred to the four determinants of national competitive advantage, as set forth by Porter (see Figure 10.1). We noted that these factors can be critical in helping a country build and maintain competitive advantage. We now consider Porter's 'diamond' framework in more depth, examining how his findings apply specifically to triad countries and determining how the ideas can be modified and applied to nations that are not triad members.

Determinants and external variables

Porter's **'diamond' model** is based on four country-specific determinants and two external variables. The determinants comprise:

1. **Factor conditions**. These include (a) the quantity, skills and cost of the personnel; (b) the abundance, quality, accessibility and cost of the nation's physical resources such as land, water, mineral deposits, timber, hydroelectric power sources and fishing grounds; (c) the nation's stock of knowledge resources, including scientific, technical and market knowledge that affect the quantity and quality of goods and services; (d) the amount and cost of capital resources that are available to finance industry; and (e) the type, quality and user cost of the infrastructure, including the nation's transportation system, communications system, healthcare system and other factors that directly affect the quality of life in the country.
2. **Demand conditions**. These include (a) the composition of demand in the home market as reflected by the various market niches that exist, buyer sophistication and how well the needs of buyers in the home market precede those of buyers in other markets; (b) the size and growth rate of the home demand; and (c) the ways in which domestic demand is internationalised and pulls a nation's products and services abroad.

3 *Related and supporting industries.* These include (a) the presence of internationally competitive supplier industries that create advantages in downstream industries through efficient, early or rapid access to cost-effective inputs; and (b) internationally competitive related industries that can coordinate and share activities in the value chain when competing or those that involve complementary products.

4 *Firm strategy, structure and rivalry.* These include (a) the ways in which firms are managed and choose to compete; (b) the goals that companies seek to attain as well as the motivations of their employees and managers; and (c) the amount of domestic rivalry and the creation and persistence of competitive advantage in the respective industry.

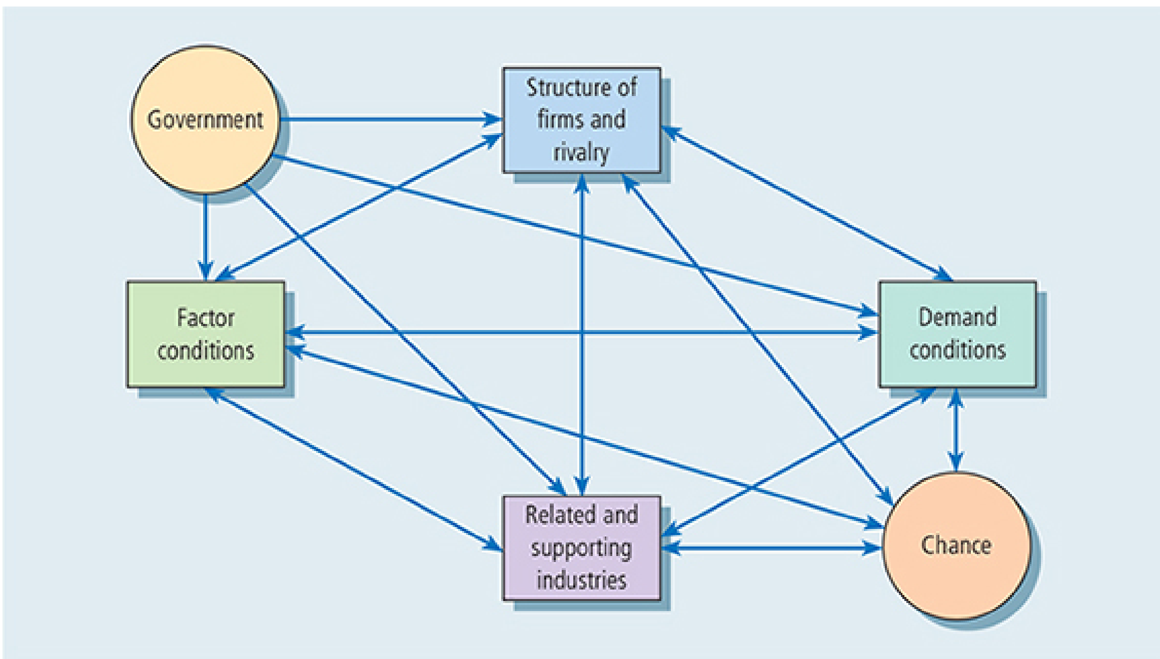

Figure 10.1 Porter's single-diamond framework

Source: Adapted from The Free Press, an imprint of Simon & Schuster Adult Publishing Group, from *The Competitive Advantage of Nations* by Michael E. Porter.

The four determinants of national advantage shape the competitive environment of industries. However, two other variables, chance and government, also play important roles:

1 *The role of chance.* Chance events can nullify the advantages of some competitors and bring about a shift in overall competitive position because of developments such as (a) new inventions, (b) political decisions by foreign governments, (c) wars, (d) significant shifts in world financial markets or exchange rates, (e) discontinuities in input costs such as oil shocks, (f) surges in world or regional demand, and (g) major technological breakthroughs.

2 *The role of government.* Government can influence all four of the major determinants through such actions as (a) subsidies, (b) education policies, (c) the regulation or deregulation of capital markets, (d) the establishment of local product standards and regulations, (e) the purchase of goods and services, (f) tax laws and (g) antitrust regulation.[1]

Figure 10.1 provides an illustration of the complete system of these determinants and external variables. Each of the four determinants affects the others, and all in turn are affected by the role of chance and government.

Critique and evaluation of the model

In applying this model to international business strategy, we must first critique and evaluate Porter's paradigm and supporting arguments. First, the Porter model was constructed based on statistical analysis of aggregate data on export shares for ten countries: Denmark, Italy, Japan, Singapore, South Korea, Sweden, Switzerland, the UK, the United States and West Germany. In addition, historical case studies were provided for four industries: the German printing press industry, the US patient monitoring equipment industry, the Italian ceramic tile industry and the Japanese robotics industry. Exports are taken to be a measure of international competitiveness, relating to both firms and their home nations.

Second, the government is of critical importance in influencing a home nation's competitive advantage. For example, it can use tariffs as a direct

entry barrier to penalise foreign firms, and it can employ subsidies as an indirect vehicle for penalising foreign-based firms. Government actions such as these, however well intentioned, can backfire and end up creating a 'sheltered' domestic industry that is unable to compete in the worldwide market.[2] Third, although chance is a critical influencing factor in international business strategy, it is extremely difficult to predict and guard against.

Fourth, in the study of international business, the Porter model must be applied in terms of company-specific considerations and not in terms of national advantages. As Porter notes so well in his book, 'Firms, not nations, compete in international markets'.[3] Fifth, in support of his model, Porter delineates four distinct stages of national competitive development: factor-driven, investment-driven, innovation-driven and wealth-driven (see Figure 10.2). In the factor-driven stage, successful industries draw their advantage almost solely from the basic factors of production such as natural resources and the nation's large, inexpensive labour pool. Although successful internationally, the industries compete primarily on price. In the investment-driven stage, companies invest in modern, efficient facilities and technology, and work to improve these investments through modification and alteration. In the innovation-driven stage, firms work to create new technology and methods through internal innovation and with assistance from suppliers and firms in related industries. In the wealth-driven stage, firms begin to lose their competitive advantage, rivalry ebbs and the motivation to invest declines. As seen in Figure 10.2, Porter believes that Singapore is in the factor-driven stage, Korea is investment driven, Japan is innovation driven, Germany and the United States are between the innovation and wealth-driven stages, and the UK is wealth driven. Because the stage of development greatly influences the country's competitive response, the placement of countries in Figure 10.2 is critical. So too is the logic that countries move from one stage to another, rather than spanning two or more stages, because there are likely to be

industries or companies in all major economies that are operating at each stage.

Sixth, Porter contends that only outward FDI is valuable in creating competitive advantage, and inbound foreign investment is never the solution to a nation's competitive problems. Moreover, foreign subsidiaries are not recognised by Porter as sources of competitive advantage.[4] These statements are questionable and have already been rejected in this text.

Seventh, as seen in Figure 10.2, reliance on natural resources (the factor-driven stage) is viewed by Porter as insufficient to create worldwide competitive stature.[5] Countries like Canada and the oil producing nations have historically shown this to be questionable. It is likely, however, that natural resources will provide only temporary competitive advantage and countries need to evolve other forms of advantage to sustain growth.

Eighth, the Porter model does not adequately address the role of MNEs. Researchers such as Dunning[6] have suggested including multinational activity as a third outside variable (in addition to chance and government). Certainly there is good reason to question whether MNE activity is covered in the 'firm strategy, structure, and rivalry' determinant, and some researchers have raised the question of how the same rivalry determinant can both include multinationality for global industries and yet exclude it for multidomestic industries. As Dunning notes, 'There is ample evidence to suggest that MNEs are influenced in their competitiveness by the configuration of the diamond in other than their home countries, and that this in turn may impinge upon the competitiveness of home countries.'[7] For example, in 2018, Nestlé earned nearly 99 per cent of its sales outside Switzerland;[8] thus, the Swiss diamond of competitive advantage is less relevant than that of the countries in which Nestlé operates. This is true not only for MNEs in Switzerland but for 95 per cent of the world's MNEs as well. For example, virtually all of Canada's large multinationals rely on sales in the United States and other triad markets.

Indeed, it could be argued that the US diamond is more relevant for Canada's industrial multinationals than Canada's own diamond, since more than 70 per cent of Canadian MNE sales take place in the United States. Other nations with MNEs based on small home diamonds include Australia, New Zealand, Finland, and many Asian countries. So in applying Porter's framework to international business at large, one conclusion is irrefutable: *Different diamonds need to be constructed and analysed for different countries*.

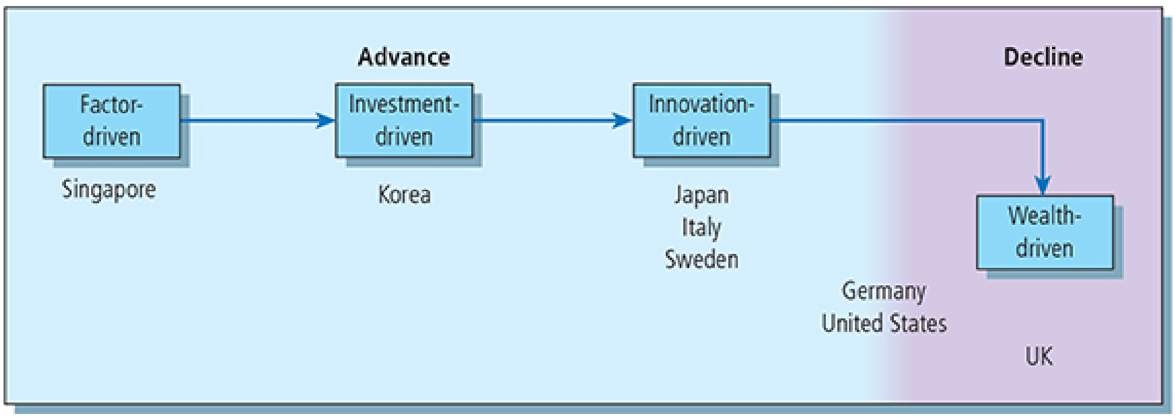

Figure 10.2 The four stages of national development and the historical position of select nations

Source: Adapted from The Free Press, an imprint of Simon & Schuster Adult Publishing Group, from *The Competitive Advantage of Nations* by Michael E. Porter.

Active learning check

Review your answer to Active Learning Case question 1 and make any changes you like. Then compare your answer to the one below.

1 In what way does ABB's strategy incorporate Porter's four country-specific determinants and two external variables?

The strategy incorporates Porter's country-specific determinants as part of a well-formulated global strategy designed to tap the strengths of various markets. Like many other MNEs it places particular functions, such manufacturing, distribution, R&D or finance, in locations where they can draw on specific factor conditions and demand conditions to provide global advantage. It also draws on supporting industries to help sustain its worldwide competitive advantage in that industry. At the same time, the company's strategy, structure and rivalry are designed to help it compete at the local level. It also takes into account government regulation, tax levels and subsidies, and inter-governmental relationships (e.g. tariff and non-tariff barriers), in determining where different activities take place. It addresses the variable of chance by operating globally and thus reducing the likelihood that a war or a regional recession will have a major negative effect on global operations. The firm's heavy focus on core technologies and R&D also helps minimise this chance variable.

THE DOUBLE DIAMOND

Researchers have recently begun using Porter's single diamond as a basis for analysing the international competitiveness of smaller countries. This approach builds on Porter's theme of corporate strategy and process as a source of competitive advantage for a nation.

Canada and the double diamond

Figure 10.3 illustrates how Porter's single diamond would look if it were applied to Canada's case.[9]

Two themes have recurred consistently in Canadian industrial policy: export promotion for natural resource industries and import substitution in the domestic arena. The Canadian market has always been seen as too small to support the development of economies of scale required in modern industry. Hence it has been the practice in Canada to provide the base for developing large-scale resource businesses that are designed to exploit the natural resources found in the country. Export strategies have emphasised commodity products that have been developed in isolation from major customers. In the past these strategies had been encouraged by US government policies that removed or eliminated tariffs on imports of commodities that are not produced extensively in the United States. The Canadian government's role had been to help leading Canadian-based businesses by establishing relatively low taxes on resource extraction and by subsidising the costs of capital through grants, low-interest loans and loan guarantees.

With respect to import substitution, the Canadian goal had been to use tariff and non-tariff measures to provide a protected environment for developing secondary industry. Under this arrangement the country's

approach to business was largely focused inwardly, relying solely on the extent and quality of natural resources as the basis for the creation of wealth.

Over time Canada adopted a more international approach to its economic development policies. The United States–Canada Free Trade Agreement allowed Canadian plants to gain economies of scale by producing for the North American market as a whole rather than for the Canadian market alone. For corporate strategy, the result of North American economic integration has been the development of a Canadian–US '**double diamond**', which shows that the two countries are integrated for strategy purposes into a single market (see Figure 10.4).

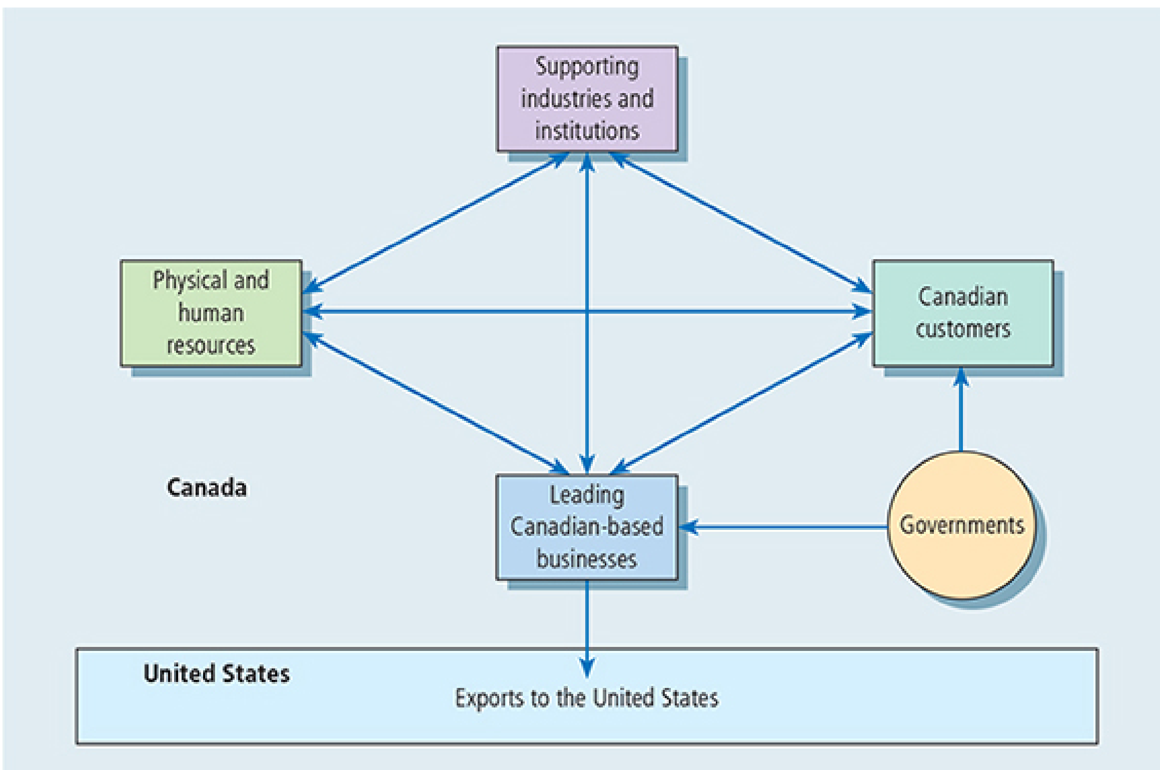

Figure 10.3 The single-diamond view

Source: Adapted from Alan M. Rugman and Joseph R. D'Cruz, *Fast Forward: Improving Canada's* International Competitiveness (Diane Publishing Co., 1991), p. 35.

Under this new arrangement, Canadian businesses began to compete more directly with firms operating in a diamond of their own in the United States.[10] To survive this rivalry with leading US firms, Canadian businesses had to develop competitive capabilities of a high order.[11] They can no longer rely on their country's home diamond and natural resource base. Innovation and cost competitiveness are equally important, and this requires strategies that are designed to access the US diamond. Now Canadian managers need a 'double-diamond perspective' for their strategic decisions. The double diamond is, of course, relevant for other small, open economies such as Finland and Sweden. The case **International Business Strategy in Action: Nokia and Ericsson** provides an example.

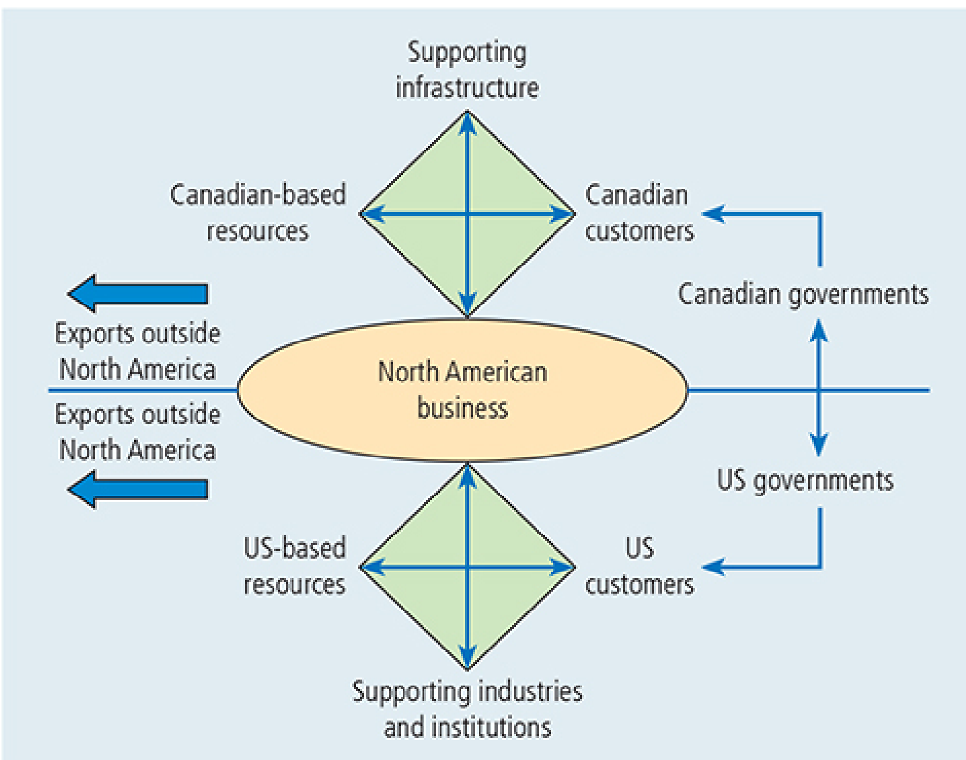

Figure 10.4 Canadian–US double diamond

Source: Adapted from Alan M. Rugman and Joseph R. D'Cruz, 'The "Double Diamond" Model of International Competitiveness: the Canadian Experience', *Management International Review*, vol. 33, Special Issue 2 (1993), p. 32.

The Free Trade Agreement has also created a series of unique pressures on the Canadian subsidiaries of US multinationals, many of which were created for the purpose of overcoming Canadian tariff barriers that were designed to encourage the development of local operations. These subsidiaries are now unnecessary, and many of them are currently in direct competition with their US-based parent. If they cannot compete successfully, future business will go south of the border.[12]

Meanwhile, major Canadian companies are working to develop competitive positions in the United States as well as worldwide. A good example is Magna International, Canada's leading diversified automotive supplier headquartered in Aurora, Ontario, Canada (**International Business Strategy in Action: Magna International Inc.** in Chapter 11). The company designs, develops and manufactures automotive systems, assemblies, modules and components, and engineers and assembles complete vehicles, primarily for sale to original equipment manufacturers (OEMs) of cars and light trucks in three geographic segments: North America, Europe and rest of world (primarily Asia and South America). It is Canada's largest automobile part manufacturer and also the 287th largest company on the 2018 Fortune Global 500. The firm has now established a significant manufacturing and product development presence in the United States. As at March 2019, the company had 348 manufacturing divisions and 91 product development, engineering and sales centres in 28 countries. In 2017, Magna accumulated $39.8 billion in revenue, approximately 53 per cent of its total revenue came from North America, 39 per cent from Europe, 7 per cent from Asia and the remaining 1 per cent from rest of the world.[13]

Bombardier Inc. provides another example. Beginning as a Canadian manufacturer of snow-going equipment, the company has now grown into a multinational firm with interests in aviation, transportation, and financial services. In the aviation/aerospace business, Bombardier has major operations

in Canada and the United States, among other locations, and manufactures a line of business aircraft, commercial aircraft, including regional jets, turboprops and single-aisle mainline jets, and amphibious aircraft.[14]

Other major Canadian firms are following suit, operating from a North American perspective in order to lay the groundwork for becoming globally competitive. This involves viewing the United States and Canada as home-based markets and integrating the use of both ‘diamonds’ for developing and implementing strategy. In particular, this requires:

- developing innovative new products and services that simultaneously meet the needs of the US and Canadian customer, recognising that close relationships with demanding US customers should set the pace and style of product development;
- drawing on the support industries and infrastructure of both the US and Canadian diamonds, realising that the US diamond is more likely to possess deeper and more efficient markets for such industries; and
- making free and full use of the physical and human resources in both countries.[15]

Strategic clusters in the double diamond

The primary advantage of using the double diamond is that it forces business and government leaders to think about management strategy and public policy in a more productive way. Rather than viewing the domestic diamond as the unit of analysis, managers from smaller countries are encouraged to always be outward looking. Doing well in a double diamond is the first step towards global success.

Once a country has recognised the benefit of the double-diamond perspective, it should first identify successful and potentially viable clusters of industries within its borders and then examine their linkages and performances across the double diamond. A **strategic cluster** is a network of

complementary businesses and supporting activities located in a specific region. Some strategic clusters have one or more large MNEs at the centre. Whether these are home or foreign owned is irrelevant so long as they are globally competitive. They are the flagship firms on which the strategic cluster depends. A vital component of the cluster is companies with related and supporting activities, including both private and public sector organisations. In addition, there are think tanks, research groups and educational institutions. Some parts of this network can even be based outside the country, but the linkages across the border and the leadership role of the nation's flagships result in world-class competitive multinationals.

Currently Canada has several strategic clusters. One is the auto assembly and auto parts industry in south-western Ontario, led by the Big Three US auto multinationals with their related and affiliated suppliers and distributors. There are linkages to various high-tech firms and research groups that span the border, as does the auto assembly industry itself. Other strategic clusters are based in banking and financial services in Toronto, advanced manufacturing and telecommunications in Toronto, forest products in western and eastern Canada, energy in Alberta, and the fisheries in Atlantic Canada. Some are led by flagship Canadian-owned multinationals such as Bombardier, Magna International and Research in Motion (RIM, best known as the developer of the BlackBerry smartphone); others are led by, or include, foreign-owned firms such as IBM Canada and DuPont Canada.[16]

INTERNATIONAL BUSINESS STRATEGY IN ACTION

Nokia and Ericsson: moving beyond mobiles

Based in one of the world's smallest countries, Finland's Nokia was once the largest producer of cell phones. Founded in 1865, Nokia was a major manufacturer of paper products before it transformed itself into a high-tech producer of electronic products, especially cellular phones, starting in the 1970s. By 2017, with over 100,000 employees Nokia was the largest company in Finland and generated sales close to US $26 billion. It had production facilities spanning 13 countries and R&D in 13 locations worldwide. In 2017, Nokia derived 22 per cent of its total sales from Europe, 32 per cent from Asia–Pacific (including China), 9 per cent from the Middle East and Africa, 6 per cent from Latin America and 31 per cent from North America.

At its height, the firm was a pioneer in mobile telephones, riding the wave of first business users then regular consumers buying a series of Nokia's early models. Then in 2009 Nokia's sales dropped by 23 per cent year-on-year and industry watchers commented that Nokia had been falling behind its competitors, particularly Apple, for some years. In February 2011, Nokia announced a strategic alliance whereby it planned to abandon its Symbian smartphone operating system in favour of Microsoft's Windows Phone 7, in order to challenge the growing popularity of phones powered by Google's Android operating software and the Apple iPhone. The Apple iPhone (driven by Apple's proprietary iOS) captured the top of the smartphone market, while devices powered by Android – free, open source software – were failing to fully challenge subsequent models of iPhones.

Between 2013 and early 2014 Nokia finally sold off its Devices and Services business to Microsoft, exiting the cell phone business. This left it with three major business divisions: Nokia Networks, its network infrastructure business; a location intelligence business (HERE); and Nokia Technologies, which includes intellectual property rights activities.

Finland has a population of approximately 5.5 million, so from the beginning Nokia has pursued foreign sales. Less than 1 per cent of sales in 2014 were from its home country. Internationalisation has always been essential for growth. The firm established itself initially as the cell phone leader in Scandinavia, despite competition from Ericsson of Sweden. From there it progressed to becoming the leader in the UK and then the rest of Europe, and formed strategic alliances with US distributors

such as RadioShack and US telecom companies like AT&T. The firm also developed special phones for Chinese and Japanese users, spending a large percentage of sales on R&D, which allowed it to continuously introduce new handset models. For example, it pioneered the development of MP3 technology that allowed cell phones to evolve into portable music players.

Founded in 1876, L. M. Ericsson has grown to employ around 100,000 people and had sales of approximately US $22 billion in 2017, in the 180 countries in which it operated. Back in 1997, Ericsson was the world's largest producer of digital cell phones.

Unlike Nokia, which started as a paper and rubber producer, Ericsson has always been in telecommunications, beginning in 1876 as a telephone manufacturer. It has always been innovative, with one in four of its employees working in R&D. As of 2017, Ericsson has over 42,000 patents, giving it a strong portfolio of intellectual property rights. Many of these relate to telephone switches, helping it compete with firms such as Nokia Siemens Networks, France's Alcatel-Lucent and Japan's NEC. Ericsson was well positioned to benefit from the telecom deregulation of the 1980s and 1990s. This created new demand, especially for new equipment like cell phones in areas with few local monopoly producers. By 2000 Ericsson was the world's leading supplier of 3G mobile systems.

Just like Nokia, Ericsson formed a range of alliances to access complementary technologies, including with Intel, Hewlett-Packard and Texas Instruments. These firms acted as key suppliers of components and products that Ericsson used for voice and data transmission. An estimated 40 per cent of global mobile traffic runs through Ericsson-developed networks, serving more than 1 billion subscribers around the world, every day. If it had a weakness, compared to Nokia and Motorola, this was perhaps its brand name and its direct consumer marketing capability. It has evolved as a strong B-to-B supplier, not as a B-to-C player.

Both Nokia from Finland and Ericsson from Sweden have successfully evolved from small domestic markets into global giants through technological innovation, complementary partnerships and a constant focus on internationalisation. But Chinese competitors, particularly Huawei, may well eclipse them.

Websites: www.nokia.com; www.ericsson.com; www.motorola.com; www.nortelnetworks.com; www.alcatel.fr; www.att.com; www.compaq.com; www.hp.com; www.intel.com; www.ti.com

Sources: Richard Milne, 'Changing fortunes for Nokia and Ericsson: Arch-rivals struggle to find good businesses beyond their core networks operations', *Financial Times*, 21 March 2018; Richard Hylton, Nick Moore and Roger Honor, 'Making money in the tech market', *Fortune*, 13 May 1996; Erick Schonfeld, 'Hold the phone: Motorola is going nowhere fast', *Fortune*, 30 March 1998; Caroline Daniel, 'World's most respected companies', *Financial Times*, 17 December 2001; Nokia, *Annual Report*, 2009, 2014, 2018; Ericsson, *Annual Report*, 2009, 2014, 2018; Alan Cane, 'Perspectives: longevity can be a tricky stunt to pull off', *Financial Times*, 16 March 2011, 'HTC phone sales beat expectations', *BBC News*, 6 July 2010; 'HTC profits double as smartphone demands grows', *BBC News*, 6 June 2011; S.C. Collinson and M. Jay, *From Complexity to Simplicity* (Basingstoke: Palgrave Macmillan, 2012).

Many Canadian clusters are resource based. The challenge for managers in these clusters is to continue to add value and eliminate the commodity nature of Canada's resource industries. One way to do this is to develop a global marketing strategy that builds on the Canadian–US double diamond instead of remaining as the extractor or harvester of resources. To implement such a global strategy requires a large investment in people who will bring strong marketing skills and develop a global intelligence network to identify the different tastes and preferences of customers. This network provides a role for smaller knowledge-intensive marketing research and consulting firms to participate in the resource-based cluster. There is also the potential for collaborative ventures.

Mexico and the double diamond

We can also adapt the Porter diamond model to analyse company strategies and international competitiveness in Mexico. The basic concepts in this framework are the same as those discussed in the Canadian diamond.

Linking to the US diamond

Mexico's linkage to the US diamond is somewhat different from Canada's. One reason is the fact that there are few home-based MNEs that have the capital to invest in the United States or Canada. (Review Chapter 3 for information on how and why FDI is used by MNEs.) In fact, as seen in Table 10.1, during the period 2003–17 Mexico's FDI in the United States increased by $26,386 million, almost a four-fold increase. In contrast, by 2003 Canada had just $2,366.3 million invested in Mexico, whereas the United States had $56,851 million there. More important, by 2017 US FDI in Canada reached $391,208 million, and Canada's FDI in the United States was even higher at $523,761 million. Overall, from 2003–17, Canada's FDI in the United States quadrupled while the United States' FDI in Canada also went up by approximately 2.1 times. Thus, Mexico's strategy with its North American neighbours relies more heavily on trade than on FDI for outward market access, while using inward FDI to help promote internal development.

Table 10.1 FDI positions by Canada, the United States and Mexico, 2003–17

	Canada's FDI in		US FDI in		Mexico's FDI in	
Year	US	Mexico	Canada	Mexico	US	Canada
2003	131,474.8	2,366.3	187,953.0	56,851.0	9,022	165.6
2004	163,083.5	2,143.5	214,931.0	63,384.0	7,592	238.5
2005	183,543.7	2,698.0	231,836.0	73,687.0	3,595	276.2
2006	192,231.6	4,425.2	205,134.0	82,965.0	5,310	199.1
2007	229,180.2	4,908.4	250,642.0	91,046.0	8,478	265.2
2008	243,111.6	3,491.0	246,483.0	87,443.0	8,420	268.2
2009	249,714.3	4,635.5	274,807.0	84,047.0	11,111	256.1
2010	251,342.0	4,902.0	295,206.0	85,751.0	10,970	191.0
2011	272,443.0	9,583.0	331,666.0	90,795.0	12,500	134.0
2012	275,598.0	10,109.0	351,460.0	104,390.0	13,618	n/a
2013	266,715.0	12,326.0	341,917.0	102,418.0	31,820	90.0
2014	328,089.0	13,046.0	370,220.0	94,482.0	33,302	884.0
2015	394,814.0	16,788.0	361,954.0	101,326.0	34,390	1,775.0
2016	447,557.0	14,878.0	365,375.0	100,734.0	34,783	1,856.0
2017	523,761.0	15,090.0	391,208.0	109,671.0	35,408	2,060.0

Sources: http://www.international.gc.ca/economist-economiste/assets/pdfs/Data/investments-investissements/FDI_by_Country/CDIA_stocks_by_Country-ENG.pdf; http://stats.oecd.org; http://www.international.gc.ca/economist-economiste/statistics-statistiques/investments-investissements.aspx?lang=eng; http://www.bea.gov/international/di1fdibal.htm; https://www.international.gc.ca/economist-economiste/statistics-statistiques/outward_inward-actifs_passif.aspx?lang=eng; https://www.bea.gov/data/intl-trade-investment/direct-investment-country-and-industry; https://www.selectusa.gov/servlet/servlet.FileDownload?file=015t0000000LKLr; https://www.selectusa.gov/servlet/servlet.FileDownload?file=015t0000000LKNE.

As seen in Figure 10.5, in 2017 US exports to Mexico were $181 billion and its imports from Mexico were $307 billion. Canada's exports to Mexico were $8.1 billion and its imports from Mexico were $22 billion. Although China imports more from the US than any country in the world, Mexico is the United States' second largest trading partner in terms of US exports. Despite Mexico acquiring a negative trade balance with the world in the past, it now runs a positive balance (as of 2017 Mexico had a positive trade balance of $62.6 billion in net exports) and a positive balance with the United States. In fact, in 2017 the US has accounted for approximately 73 per cent of Mexico's exports and approximately 51 per cent of its imports. So Mexico is closely linked with the US economy, and its economic growth will depend heavily on participation in this North American market.

Maquiladoras

In 1965 the Mexican government established the *maquiladora* industry to attract foreign manufacturing operations. Imported products for the *maquiladoras'* production are exempt from Mexican duties as long as they are used for exports. By the early 2000s the 12 original plants in 1965 had grown to 2,900.[17] Principally US owned, these businesses were widely considered to have established a basis for more intensified economic cooperation anticipated under an FTA. Then competition from China and other emerging

economies with cheap labour reduced the scale of the *maquiladora* industry. Despite some decline following the 2008 credit crisis, and subsequent growth, by 2019 it had not grown much over 3,000 firms.

What will the future hold regarding Mexico and North America? The most likely developments will be continued investment by US and Canadian firms and the establishment of worldwide competition there. Mexico was manufacturing and shipping many more products back north as well as exporting to more countries than it did before NAFTA. Canada is still trying to create and nurture Canadian-owned MNEs that will compete worldwide. Mexico hopes to build these businesses internally with financial and technological investments, primarily from its North American neighbours.

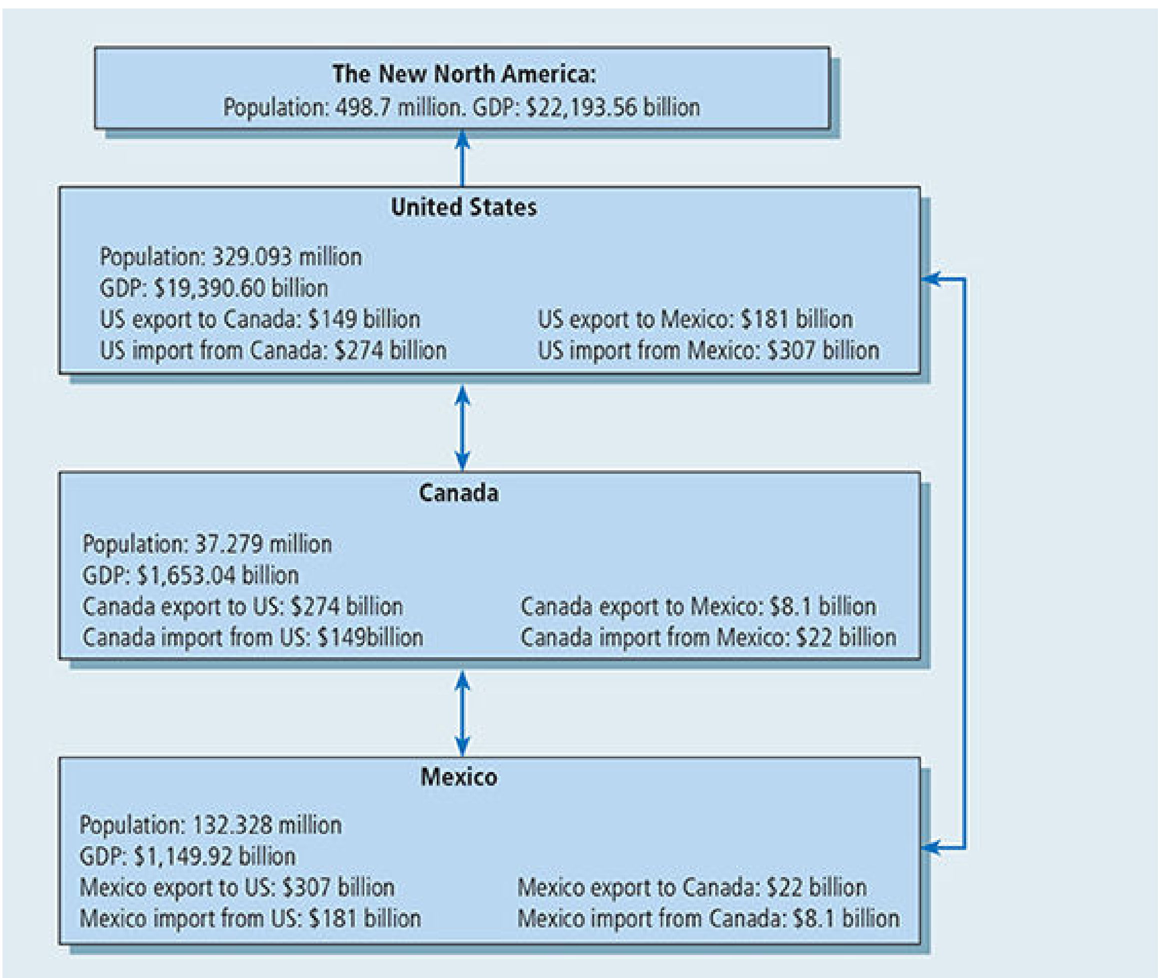

Figure 10.5 The shape of North America

Source: (Population 2018 – figures from http://www.worldometers.info/world-population/population-by-country/) (GDP 2017 – figures from https://tradingeconomics.com/united-states/gdp) (Import/Export 2017 – from https://atlas.media.mit.edu/en/profile/country/usa/).

The double-diamond examples of Canada and Mexico help explain how MNEs can use Porter's ideas to formulate strategies. However, these firms also need to address the issue of national responsiveness, the focus of the discussion in the next section.

✔ Active learning check

Review your answer to Active Learning Case question 2 and make any changes you like. Then compare your answer to the one below.

2 Why did ABB buy Gomtec GmbH? How can the company link this small firm into its global strategy and structure?

ABB bought Gomtec GmbH for a number of reasons. This small German firm provided new technologies and expertise in the area of human–robot interaction. The interface between humans and robots is a focal point for innovation and therefore competitive advantage in a number of ABB's product divisions. ABB has installed 250,000 robots in its own products and those of clients around the world. It therefore needs to keep ahead of the competition by developing or acquiring the leading technology and knowledge to improve both the robots and the interface between these and human controllers. Once a firm has selected a strategy, in this case to acquire particular assets and capabilities to innovate and add value to products and services, it needs to incorporate these acquired assets and capabilities into its global structure so it can leverage them effectively. So ABB needs to integrate this small firm, Gomtec GmbH based in Munich, within its global matrix structure, to ensure that it maximises the added value obtained through the synergies it anticipated when it targeted this acquisition. In many cases, when giant multinationals buy SMEs, a key indicator of success is the retention of the key players in the small firm. If they leave, ABB will have lost the expertise that underpins the added value of the acquisition when combined with ABB's own people and assets.

INTEGRATION AND RESPONSIVENESS

National responsiveness is the ability of MNEs to customise products and services according to different consumer tastes in segmented regional markets and to respond to the different national standards and regulations imposed by autonomous governments and agencies. This demands differentiation, or a customisation of products, services, brands as well as working practices to suit local conditions. This will support certain kinds of competitive advantage, but reduce others, such as the economies of scale derived when a global firm produces and sells the same products, using the same brand in all markets. Multinational managers have to continuously balance the twin goals of economic integration (consolidation) and national responsiveness (differentiation). See the case **International Business Strategy in Action: Renewed advantage through vertical integration at Floreal Knitwear**.

Integration versus national responsiveness

Figure 10.6 is designed to help MNE managers cope with the trade-offs between integration and national responsiveness. The framework originated in the work of Bartlett, and Bartlett and Ghoshal.[18] The vertical axis provides a scale from a high level of integration (globally consolidated) to a low level. Movement along the axis results in a greater degree of economic integration, which generates economies of scale as a firm consolidates functions (such as production, marketing, R&D) and centralises decision-making. These economies are also captured as a firm reaps the benefits of simplified coordination and increased control of different value-chain activities.

The horizontal axis measures the need for corporations to be nationally responsive. Companies must address local tastes and government regulations,

which may result in a need for geographic dispersion of activities or a decentralisation of coordination and control for individual firms.

On the basis of the two axes in Figure 10.6, four situations can be distinguished. Quadrants 1 and 4 are the simplest cases. In quadrant 1, the benefits of integration are high and the need to respond to local differences is low. This focus on economies of scale leads to competitive strategies that are based on price competition. In such an environment, mergers and acquisitions often occur.

Figure 10.6 High and low levels of integration vs. diversification

The opposite situation is represented by quadrant 4, where the need for national responsiveness is high and the benefits of integration are low. In this case, companies build a wider portfolio of different products and services that satisfy the different demands of each market.

INTERNATIONAL BUSINESS STRATEGY IN ACTION

Renewed advantage through vertical integration at Floreal Knitwear

Based in Mauritius, Floreal Knitwear Ltd (Floreal) is the leading knitwear manufacturer in Sub-Saharan Africa and the second largest woolmark knitwear supplier in the world, after Benetton. Founded in 1971 by a group of Hong Kong investors, Floreal was the first African factory to produce sweaters of world-class quality. Its rapid success attracted attention and a larger textile conglomerate, named CIEL, acquired Floreal in 1973. The company enjoyed a period of steady growth and won several international awards and recognitions for its products up until the late 1990s.

The Asian crisis hit in 1997 and, up until 2000, several factors had culminated to have a significant impact on Floreal's operations. Among these were a fall in the price of sweaters in the United States and Europe (10 per cent in three years); an appreciation of the Mauritian rupee against the euro by 20 per cent in just a few months; a rise in labour costs by 27 per cent in the garment sector; and an increase in production costs by 31 per cent between June 1997 and April 2000. The cumulative effect of these factors was to drive down the profit of Floreal from Rs43 million ($US1.6 million) in June 1997 to a loss of Rs175 million ($US6.4 million) in July 2000. Its ability to compete globally with strengthening competition from India and Bangladesh was looking increasingly weak. Floreal had started to lose in terms of both its price competitiveness, based on costs of production that had now changed, and its innovative product design and development operations, which were not keeping up with fast-moving markets and competitors.

Floreal had rethink how to re-engineer its operations in order to minimise its overheads, keep innovating and improve productivity as quickly as possible. It had to change its position in the global value chain for knitwear products in order to survive. So the firm embarked on a strategic re-engineering exercise in which the structures and systems of all its departments were reviewed and changed; it pruned out all non-value-adding jobs, developed an outsourcing strategy, and established stronger performance control at all levels. The restructuring exercise reduced its workforce by 11 per cent. Also, with further help from CIEL, it (vertically) integrated its R&D by establishing the Ferney

Spinning Mills (a wool spinning factory with over 30 years of experience in high-quality wool and wool blend yarns), which now supplies 70 per cent of its yarn needs and is its main source of innovation for its world-quality products. Floreal also invested in a world-class wet processing plant where it processed both cotton and wool garment dyeing. To counter the effects of rising labour costs, Floreal opened manufacturing operations in Madagascar and Bangladesh. Both locations have an abundance of cheap but highly talented labour, and they were also the prime sourcing destinations of its clients. Overnight, Floreal turned its head office in Mauritius into a knowledge-based hub for innovations, strategic thinking and global marketing.

Vertical integration along the value chain continues to be a source of competitive advantage for Floreal today. It now has full control of the quality of the yarn fibre to the finished product. This, along with improved market responsiveness through quick product innovations, tailored around the specific needs of customers and markets. The leading products of the moment are its ‘vintage wool’, ‘Tropical dye’ (washed cotton) and ‘Total Easy Care’, which is a huge success in the US market. Floreal is now an established global player and has factories in Mauritius, Madagascar and Bangladesh. Moreover, the firm has marketing and support offices in the United Kingdom, South Africa, Hong Kong and China. It supplies goods to some leading brands such as Marks & Spencer, Lyle & Scott, John Lewis, Celio, Galeries Lafayette, Peek & Cloppenburg, Pringle and Gazman. In 2018 Ciel overall had 19 production units, including 7 in Mauritius, over 20,000 employees exporting about 36 million garments each year.

Sources: http://www.cielgroup.com/textile; N. Rogovsky, P. Ozoux, D. Esser, T. Marpe and A. Broughton, *Restructuring for Corporate Success: A Socially Sensitive Approach* (Geneva: International Labor Office, 2005); D. C. Wood, *Production, Consumption, Business and the Economy: Structural Ideals and Moral Realities* (Bingley: Emerald Group Publishing, 2014); ‘40 years of Floreal Knitwear: ‘our strategy of diversification was good’’, http://business.mega.mu, 18 October 2012; http://www.ide.go.jp/English/Data/Africa_file/Company/mauritius03.html; Michelle Russell, ‘Analysis: Mauritius apparel sector faces up to challenges’, *Just Style*, 22 May 2014.

Quadrants 2 and 3 also reflect opposing situations. Quadrant 2 incorporates those cases where the benefits of both integration and national responsiveness

are low. There are fewer opportunities to, or benefits from, integrating functions, so significant economies of scale are not feasible. There is also little advantage or value in customising individual products or services for specific markets.

In quadrant 3 the benefits of integration and national responsiveness are both high. Significant cost-competitiveness can be gained by integrating production facilities, for example, but there may also be a need to develop local adaptations in marketing. Quadrant 3 is the most challenging and the one in which many successful 'transnational' MNEs operate. Using this framework, we can analyse the impact of various exogenous policy shocks and trends on different industries, firms, banks and other private sector institutions.

Balancing the trade-offs

MNEs in every industry apply the ideas in Figure 10.6, but they do so in a variety of ways. The following are select examples from two different industries: entertainment and automobiles.

Entertainment

One of the most successful entertainment firms in the world is the Walt Disney Company. Its Disneyland Paris operation in France is a good example of how integration and national responsiveness are balanced. The park offers many of the same features (integration) found in Disney's Orlando (Florida), Anaheim (California) and Tokyo operations, including amusement rides and film and cartoon characters. The company has recently expanded its European facilities along the lines of its MGM studios near Orlando. Stressing uniformity among the geographically scattered parks, this integration focus is supplemented by national responsiveness that is designed to appeal to European visitors. English and French are the official languages of the park,

and multilingual guides are conversant in Dutch, German, Spanish and Italian. A second example of national responsiveness is found in the different kinds of restaurants located in each park, reflecting different cultural preferences of local populations.

Automobiles

Every car manufacturer uses economic integration by producing autos that can be made and marketed around the world. In a few cases, the Volkswagen Beetle being the best example, a car will not need to be modified for the local market. Usually, however, car firms gain economies of scale by producing a standard platform (chassis, powertrain and often engine) and change elements of the exterior and interior design, features and fittings to respond to local tastes. The Volkswagen Golf and the Audi TT, for example, share the same platform. Ford's Mondeo was developed for the world market with uniform worldwide engineering standards and uniform standards for raw materials, design, procurement and manufacture of individual parts. Identical production tools are used at both European and US locations so that economies of scale can be maximised. At the same time, Ford has taken national responsiveness into consideration. European buyers prefer manual transmissions, whereas US buyers like automatic drive. Europeans demand cars that handle well, but this is not a priority issue with American customers. On the other hand, Americans want air-conditioned cars, and many Europeans do not. The overall cost of developing the Mondeo was $6 billion. But the economies of scale, in R&D, production and other parts of the value chain gained by using the platform in other makes and models underpin a competitive advantage for the firm globally.

Honda offers another example of integration and national responsiveness strategies. The firm now builds a variety of different car sizes from one production platform by bending and stretching the autos to fit the demands of

the market. As a result, Honda is able to build cars in the United States that are longer and roomier, while offering smaller, more compact models of the same car in Japan.

General Motors offers yet another example of integration and national responsiveness strategies. Like Ford, GM often develops cars for the European market, then introduces them into the United States. As a result, the cars are frequently identical in styling and design but have different features to accommodate local tastes. The Celta, a subcompact offering in Brazil, has fewer features and 50 per cent fewer parts than competitive models. In collaboration with its suppliers, GM created a modular assembly plant with just-in-time supplier delivery. Efficiency costs of such an integration strategy allowed for an inexpensive subcompact for developing markets, where price and reliability are most important. When the auto is made in another developing market, it will be possible to build and assemble each unit quickly because the process will have been perfected in Brazil. This integration focus is complemented by national responsiveness. In Brazil, marketing of the Celta stresses security locks and anti-theft devices, whereas in safer developing countries, the car's suspension system and handling on tough roads will receive more emphasis.

Active learning check

Review your answer to Active Learning Case question 3 and make any changes you like. Then compare your answer to the one below.

3 How does ABB address the issues of global integration and national responsiveness? In each case, cite an example.

ABB addresses the issue of globalisation by producing state-of-the-art products for worldwide markets. It may be necessary to make modifications to address local geographic and climatic conditions, of course, but the basic technology and manufacturing techniques are similar. The firm consolidates many of its production and R&D activities to benefit from the economies of scale derived by integration. At the same time, ABB addresses national responsiveness by giving decision-making power to country managers to create local relationships with customers, banks and government organisations in ways the suit local cultural and institutional norms. As a result, the company balances globalisation and local sovereignty – a feat that most MNEs do not accomplish very well.

KEY POINTS

1 Porter's single-diamond model is based on four country-specific determinants and two external variables (chance and government). This model is extremely useful in examining strategies among triad and other economically developed countries. However, when applying the model to smaller, open, trading economies, a modification is in order.

2 Canada's economic success will depend on its ability to view itself as part of the North American market and to integrate itself into this overall market. This requires the use of a 'double-diamond' model for corporate strategy, resulting in Canadian firms developing competitive capabilities that allow them to compete successfully with US firms in the United States. This is being done by (a) developing innovative products and services that simultaneously meet the needs of the US and Canadian customer, (b) drawing on the support industries and infrastructure of both the US and Canadian diamonds, and (c) making free and full use of the physical and human resources in both countries.

3 Mexico's economic success also depends on its ability to integrate itself into the North American market. However, this strategy is different from that of the Canadians because Mexico does not have the FDI to invest in the US market. Much of its linkage is a result of low labour costs that allow the country to produce inexpensive goods and export them into the United States. The North American Free Trade Agreement worked out with the United States and Canada in 1993 has continued to shape part of Mexico's ongoing economic success.

4 A major trend that has affected the thinking of corporate MNE strategists over the past ten years is balancing a concern for economic integration

and global consolidation of functions with that of national responsiveness. Many MNEs have focused on integration without giving sufficient attention to the need to localise.

Key terms

- **diamond model**
- **factor conditions**
- **demand conditions**
- **double diamond**
- **strategic cluster**
- **national responsiveness**

REVIEW AND DISCUSSION QUESTIONS

1. Porter's diamond is based on four country-specific determinants and two external variables. What does this statement mean? Put it in your own words.
2. Porter notes, 'Firms, not individual nations, compete in international markets.' How does this statement help explain some of the major challenges facing MNEs?
3. Using Figure 10.2 as your point of reference, how does the current national development of the United States differ from that of Korea? How does the UK's differ from that of Singapore?
4. Why does Porter's diamond need to be modified in explaining the international competitiveness of countries such as Canada and Mexico?
5. How does the double diamond, as illustrated in Figure 10.4, help explain international competitiveness in Canada?
6. How can Canadian firms view the United States and Canada as home-based markets and integrate the use of both diamonds for developing and implementing strategy? Be complete in your answer.
7. Of what value are strategic clusters in the double diamond? Explain.
8. How does Figure 10.6 help to explain Mexico's international business strategy?
9. How important are the *maquiladoras* to the growth of the Mexican economy? In what way do these businesses link Mexico with the Canadian–US double diamond?
10. In what way are economic integration/globalisation and national responsiveness important to MNE strategies?
11. In the entertainment industry, which is more important, integration or national responsiveness?
12. Based on current developments in the PC market in Japan, which is more important for US MNEs, integration or national responsiveness? Why?
13. Which is more important for US auto makers doing business in Europe, integration or national responsiveness? Why?

REAL CASE

The global beer industry: decline and growth at the same time?

Although beer is widely consumed around the world and is one of the oldest beverages, the beer industry is facing quite a few challenges. From 2010 to 2018, the industry has generally experienced reduced or even stagnant market growth. A combination of factors are to blame, including structural challenges, tighter regulation, more competition and a change in consumer purchasing habits.

According to some reports, the global consumption levels of beer have reached a tipping point, but consumption patterns vary by region. North America, as well as other traditional beer markets, have generally observed little growth. Political factors have not helped the sales of beer in the US, which behind China is the second largest beer market in the world. The US and China trade-war (see **Active Learning Case:** US–China trade war: battle of the giants in Chapter 6) first materialised when Trump placed tariffs on aluminium in 2018, which has not helped the growth of the beer industry in the US. For instance, although 98 per cent of aluminium cans used in the US were produced domestically, the materials used to make aluminium were actually purchased from other countries.

Developing markets have experienced relatively healthy rates of growth in beer consumption. For instance, Latin America, which accounts for 17 per cent of the world beer market, saw demand grow at an annual rate of 1.2 per cent from 2011 to 2016. Mexico plays an important role in the growth of the industry in Latin America and it experienced a significant average annual growth rate of 3.4 per cent. It is important to note that beer prices dramatically vary around the world (see Figure 10.7), with cheaper regions generally demonstrating higher levels of industry growth. In 2018, the cheapest place to purchase a pint of beer was Manila (Philippines) at a cost of $1.50. In contrast, the most expensive place to buy a pint of beer was Dubai (UAE) at a cost of staggering $12.00.

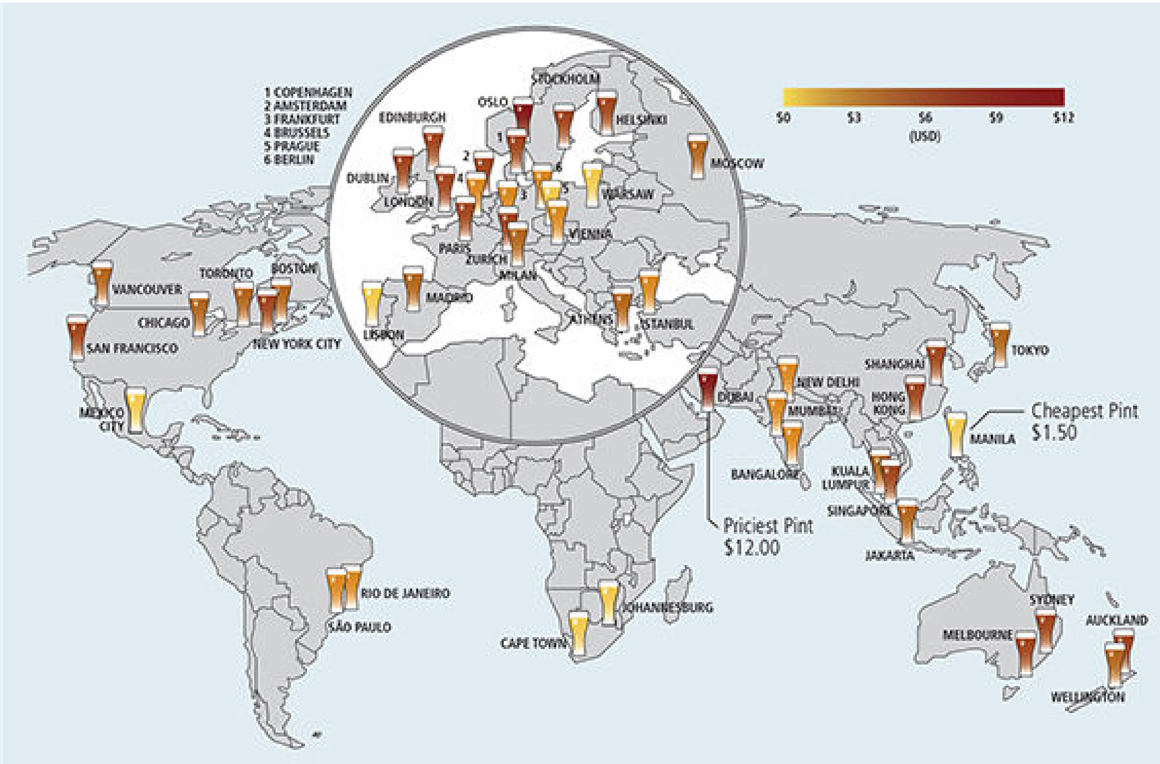

Figure 10.7 The price of a pint around the world, 2018

Source: https://www.visualcapitalist.com/mapping-price-of-beer-around-world/.

The rise of craft beer

Although consumers can purchase beer from various regions of the world, the industry is rather locally oriented. Beer is bulky and inevitably rather expensive to export. Given this, foreign producers often license their brand name products to local producers to gain a presence in different localities. In addition, imports of alcoholic beverages are traditionally subject to heavy taxation.

Recently, competitive pressure has increased dramatically in the craft and super premium segments, which is a sector in the industry that has experienced strong growth (see Figure 10.8). More specifically, craft, import and super premium segments accounted for 20.6 per cent of the beer market in 2005, but this grew to 35.1 per cent in 2015. Importantly, in these profitable sectors, economies of scale are seen to less important than innovation, explaining how these niche organisations are able compete successfully.

The rise of craft, import and super premium beer seems to be a global trend. For instance, in Europe from 2007 to 2012, Italy, Czech Republic, Spain and France witnessed eight, five, four and

three times more new beer products on retailers' shelves. Generally, the UK beer market had been slower to adapt to this trend, but from 2013–14 British retailers doubled the beer products on their shelves. Germany, home of the oldest active brewery, was slow to adopt craft, import and super premium beer. This is because of Germany's 'Deutsches Reinheitsgebot', commonly known as the 'purity law'. Drafted in 1516, the purity law states that beer is only permitted to contain four ingredients, namely: malted barley, hops, water and yeast. However, similar to the UK, 2014 was an important year as beer consumers in Germany seemed to embrace products by several US craft beer makers and started to experiment with home-grown innovative products of their own.

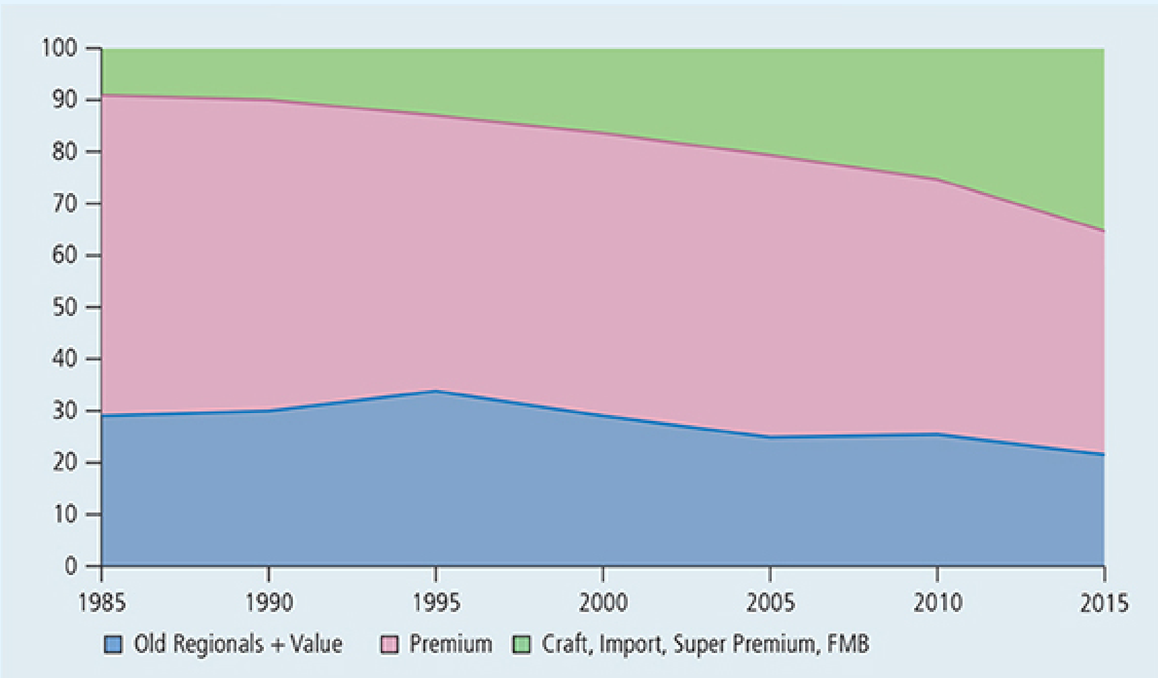

Figure 10.8 Beer market share by segment, 1985–2015

Source: https://www.brewersassociation.org/insights/premiumisation-prices-and-positioning/.

Table 10.2 Largest worldwide brewers in terms of volume, 2010–16

	2010	2011	2012	2013	2014	2015	2016
1. ABI	26.5%	26.4%	26.2%	25.9%	26.2%	26.8%	27.3%
2. Heineken	8.7%	8.8%	9.0%	9.0%	9.1%	9.4%	9.7%
3. China Resources	5.4%	5.8%	5.8%	6.2%	6.0%	6.0%	6.1%
4. Carlsberg	6.4%	6.4%	6.4%	6.3%	6.1%	5.9%	5.9%
5. Molson Coors	5.6%	5.4%	5.2%	5.1%	5.0%	5.0%	4.9%
6. Tsing Tao	3.6%	3.7%	4.0%	4.4%	4.6%	4.4%	4.1%
7. Asahi	3.5%	3.4%	3.4%	3.2%	3.3%	3.3%	3.4%
8. Beijing Yanjing	2.7%	2.9%	2.8%	2.9%	2.7%	2.5%	2.2%
9. Kirin	2.7%	2.5%	2.5%	2.4%	2.3%	2.3%	2.2%
10. Constellation	0.9%	0.9%	1.0%	1.0%	1.1%	1.2%	1.3%
Top 10 Total	66.0%	66.2%	66.3%	66.4%	66.4%	66.8%	67.1%
Others	34.1%	33.9%	33.7%	33.6%	33.6%	33.3%	32.9%

Source: https://www.jpmorgan.com/global/research/beer-market.

Largest brewers

In 2008, Belgium-based InBev acquired Anheuser-Busch for $52 billion in equity. This acquisition created the world's largest beer company, namely, Anheuser-Busch InBev (ABI). With over 200 beer brands the giant has an extensive portfolio of products. Some of these brands include Budweiser, Stella Artois, Beck's, Leffe, Bud Light and Skol. Table 10.2 shows that in terms of volume, ABI has consecutively held the title of the largest brewer in the world, with its closest rival Heineken producing approximately one third of ABI's beer output. In 2018, ABI's total sales were worth $54.619 billion, of which 19 per cent were generated in North America, which is significantly less than the 45.79 per cent generated there in 2009. Moreover, in 2018 approximately 19 per cent of revenue was acquired in Latin America–North, 6 per cent in Latin America–South, 17 per cent in Latin America–West, 22 per cent in Europe, the Middle East and Africa, and 17 per cent in Asia-Pacific. China Resources, Carlsberg and Molson Coors are the third, fourth and fifth largest brewers in the world respectively In terms of volume, the top five brewers acquired a market share of 54 per cent, and the top ten accounted for 67.1 per cent of the market in 2016.

In conclusion, the global beer industry is generally experiencing a reduction in consumer demand, an increase in competitive products and tougher conditions for those seeking to enter the market. Generally, industry growth in developed economies has stagnated or declined, whereas growth in developing countries has been more positive. Although there have been some exceptional performers

within the beer segment, namely craft beers, this has worked against the interests of large international brands who exploit economies of scale from more standardised global products, branding and marketing to achieve lower prices. A growing proportion of domestic markets are dominated by local brewers. Although the beer industry is rather saturated, given low levels of growth and considering the rise of craft beer, within the next few years it would not be surprising if the top brewers place a greater emphasis on acquiring more local providers, in turn consolidating the industry.

Websites: www.molsoncoors.com; www.heineken.com; www.ab-inbev.com; www.sabmiller.com; www.carlsberg.com; www.asahi.com; www.kirin.com

Sources: Anheuser-Busch InBev, Annual Report, 2008, 2018; https://www.visualcapitalist.com/mapping-price-of-beer-around-world/; https://www.mckinsey.com/business-functions/marketing-and-sales/our-insights/a-perfect-storm-brewing-in-the-global-beer-business; https://www.jpmorgan.com/global/research/beer-market.

1 Discuss whether the beer industry is growing or declining.

2 Is the production and distribution of beer nationally responsive?

3 If beer is mainly local, why are there mergers and acquisitions of beer companies?

4 In the integration/responsiveness matrix, where would you position the world’s largest brand-name beer companies and why?

REAL CASE

IBM

In 1911, four recording and processing equipment manufacturers in the United States merged to form the Computer-Tabulating-Recording Company (C-T-R). The new company merged its Canadian operations in 1917 under the name of International Business Machines Company. This name was adopted by all the company's operations in 1924; today, most people simply recognise it as IBM.

A pioneer of the personal computer (PC), IBM is also well known for leading the way to globalisation. However, the computer industry is at a mature stage of manufacturing. Eventually in 2004, IBM got out of personal computers altogether, selling the business to China's Lenovo as PCs became commoditised.

In 2017, its operations spanned more than 170 countries with over 350,000 employees worldwide and its research laboratories were located in 12 countries across the globe with approximately 3,000 researchers working in these laboratories. According to 'Fortune Global 500', IBM was ranked 92nd in terms of size and had revenues amounting to $79.59 billion in 2018. The organisation derived 47 per cent of all its revenue from the Americas, compared to 31 per cent from Europe, the Middle East and Africa, and 12 per cent from Asia-Pacific.

Production is also spread around the world. Product lines are clustered in regions that offer plentiful labour or specialised technology, depending on the nature of the product. ThinkPads used to be manufactured in Shenzhen, China; desktops in Guadalajara, Mexico. This reliance on developing countries allows IBM to take advantage of low labour costs while placing the company inside some of the fastest-growing markets in the world.

IBM was an international company at its conception. C-T-R brought together the international operations of all its predecessors. In the decades following its establishment, the company aggressively pursued expansion across the world. In Latin America, an office opened in Brazil in 1917. Within the next 20 years, IBM secured contracts with governments and corporations in Argentina, Mexico, Ecuador, Chile, Cuba, Uruguay and Peru. In Asia, the company opened its first office in Bombay, India, in 1920. The Philippine market was entered in 1925, followed the next year

by the first IBM equipment being installed in Osaka, Japan, for the Nippon Mutual Life Insurance Company. In China, the first IBM machines were installed at the Peking Union Medical College in 1934.

IBM's entry into the European market started when a branch of the International Time Recording Company, an IBM forerunner, opened in France in 1914. It was only in 1919 that a consolidated IBM was introduced in Europe. In the 1920s and 1930s, IBM manufacturing facilities sprang up in Germany, France, England and Italy.

Although IBM's organisational segments are product based, a company sales and distribution segment has a geographic focus as well as a specialised and global industry focus. Small and medium business contracts are dealt with through a global sales and distribution segment. Its foreign subsidiaries share technology, logistics, business principles and a common source of manufacturing, but have the power to implement local strategies. In other words, they can choose their product lines and marketing strategy to respond to the needs of the local environment, including regulations, customer tastes, income levels and the competitive environment.

In terms of production, IBM's highest commitment to globalising production is its growing reliance on electronic manufacturing service providers. More than two-thirds of the company's Intel-based products are manufactured in worldwide factories by contract manufacturers, including Sanmina-SCI and Solectron. (See the **Real Case: Flextronics** in Chapter 12.)

Source: Iain Masterton/arabianEye/Getty Images

IBM is one of only a few companies that have successfully penetrated foreign regional markets in terms of revenues and production. A main reason is that the computer, office and electronics industry in which IBM operates is one of the most global, with average intra-regional sales of over 50 per cent. Electronics are easy to transport and are standardised across all world regions. Seven of the nine largest global firms are from this industry. This extra-regionality is the result of standardised components that can be transported cheaply across the world, allowing for a global supply chain.

In terms of assets, however, IBM is highly intra-regional, as approximately 47 per cent of its assets are in the United States. There are a number of reasons for this: (1) foreign production facilities are often owned by contract manufacturers; (2) the cost of land and equipment is higher in the United States than in many of the developing countries in which the company manufactures; and (3) the United States remains the most important market for IBM. Indeed, although IBM makes nearly 20 per cent of its sales in each triad market, the Americas continue to account for the largest portion. It is difficult to argue that this is merely the result of a home-region advantage. The United States is, after all, the largest triad economy and the largest market for technology products.

Sources: www.ibm.com; IBM, *Annual Report*, 2009, 2014, 2018; Alan M. Rugman, *The Regional Multinationals* (Cambridge: Cambridge University Press, 2005); 'IBM outsourcing to Solectron, Sanmina-SCI', *Internet News*, 7 January 2003; 'Fortune Global 500', *Fortune*, 2010, 2015, 2018.

1 Is IBM a multinational enterprise? Is it global?

2 How does contract manufacturing fit into IBM's strategy?

3 Using the integration and national responsiveness matrix, in what quadrant does IBM's strategy fall?

NOTES

1 For a detailed discussion of these variables and determinants, see Michael E. Porter, *The Competitive Advantage of Nations* (New York: Free Press, 1990), pp. 69–130.

2 Alan M. Rugman and Alain Verbeke, *Global Corporate Strategy and Trade Policy* (London and New York: Routledge, 1990).

3 Michael E. Porter, *The Competitive Advantage of Nations* (New York: Free Press, 1990), p. 33.

4 Ibid., p. 671.

5 See Alan M. Rugman, 'Strategies for national competitiveness', *Long Range Planning*, vol. 20, no. 3 (1987), pp. 92–7.

6 John H. Dunning, 'Dunning on Porter.' Paper presented at the Annual Meeting of the Academy of International Business, Toronto, October 1990, and published in John H. Dunning, *The Globalization of Business* (London and New York: Routledge, 1993); and John H. Dunning, 'Internationalizing Porter's diamond', *Management International Review*, vol. 33, special issue 2 (1993), pp. 7–16.

7 Ibid., 1990, p. 11.

8 United Nations, *World Investment Report* (New York: United Nations, 2000); and see also Nestlé, *Annual Reports*, 2006–18.

9 Alan M. Rugman and Joseph R. D'Cruz, *Fast Forward: Improving Canada's International Competitiveness* (Toronto: Kodak Canada, 1991); and Alan M. Rugman and Joseph R. D'Cruz, 'The "double diamond" model of international competitiveness: the Canadian experience', *Management International Review*, vol. 33, special issue 2 (1993), pp. 17–40.

10 Alan M. Rugman, ‘The free trade agreement and the global economy’, *Business Quarterly* (summer 1988), pp. 13–20.

11 Alan M. Rugman and Alain Verbeke, ‘Strategic responses to free trade’, *Hitotsubashi Journal of Commerce and Management* (December 1988), pp. 69–79; and Alan M. Rugman and Alain Verbeke, ‘Foreign subsidiaries and multinational strategic management: an extension and correction of Porter’s single diamond framework’, *Management International Review*, vol. 33, special issue 2 (1993), pp. 71–84.

12 See, for example, Joseph R. D’Cruz and James Fleck, *Yankee Canadians in the Global Economy* (London, Ontario: National Centre for Management Research and Development, 1987); and Alan M. Rugman and Joseph D’Cruz, *New Visions for Canadian Business: Strategies for Competing in the Global Economy* (Toronto: Kodak Canada, 1990).

13 www.magna.com; Magna, *Annual Report*, 2017; ‘Global Fortune 500’, *Forbes*, 2018

14 www.bombardier.com; Bombardier, *Annual Report, 2010*; ‘Global Fortune 500’, *Forbes*, 2010.

15 Also, see Alan M. Rugman and Alain Verbeke, ‘Multinational corporate strategy and the Canada–US free trade agreement’, *Management International Review*, vol. 30, no. 3 (1990), pp. 253–66; and Alan M. Rugman and Alain Verbeke, ‘How to operationalize Porter’s diamond of international competitiveness’, *International Executive*, vol. 35, no. 4 (July/August 1993), pp. 283–99.

16 Joseph D’Cruz and Alan Rugman, *New Compacts of Canadian Competitiveness*, pp. 29–36; and see also ‘Global Fortune 500’, *Forbes*, 2009–2011 issues.

17 Alan Rugman and Alan Verbeke, ‘Foreign direct investment in North America’, p. 12; and Geri Smith, ‘Made in the Maquilas again’, *Business Week*, 16 August 2004.

18 Christopher A. Bartlett, ‘Building and managing the transnational: the new organizational challenge’, in M. E. Porter (ed.), *Competition in Global Industries* (Boston, MA: Harvard Business School Press, 1986), pp. 367–401; and Christopher A. Bartlett and Sumantra Ghoshal, *Managing Across Borders: The Transnational Solution* (Boston, MA: Harvard Business School Press, 1989).

BIBLIOGRAPHY

Arregle, Jean-Luc, Beamish, Paul W. and Hébert, Louis. 'The regional dimension of MNEs' foreign subsidiary localization', *Journal of International Business Studies*, vol. 40 (January 2009).

Asmussen, Christian Geisler, Pedersen, Torben and Dhanaraj, Charles. 'Host-country environment and subsidiary competence: extending the diamond network model', *Journal of International Business Studies*, vol. 40, no. 1 (2009).

Bartlett, Christopher and Ghoshal, Sumantra. *Transnational Management* (Boston, MA: Irwin, 1992).

Bartlett, Christopher and Ghoshal, Sumantra. *Managing Across Borders: The Transnational Solution*, 2nd ed. (Boston, MA: Harvard Business School Press, 1998).

Birkinshaw, Julian and Pedersen, Torben. 'Strategy and management in MNE subsidiaries.' In Alan M. Rugman (ed.), *The Oxford Handbook of International Business* (Oxford: Oxford University Press, 2009).

Buckley, Peter J., Chen Liang, Clegg, L. Jeremy and Voss, Hinrich. 'Risk propensity in the foreign direct investment location decision of emerging multinationals', *Journal of International Business Studies*, vol. 49, no. 2 (2018).

Cho, Dong-Sung, Moon, Hwy-Chang Moon and Kim, Min-Young, 'Does one size fit all? A dual double diamond approach to country-specific advantages', *Asian Business and Management*, vol. 8, no. 1 (2009).

Collinson, Simon C., Sullivan-Taylor, Bridgette and Wilson, David C. 'Extending the integration–responsiveness framework: delivering a

global service strategy at British Airways', *Strategic Innovators Journal*, vol. 3, no. 3 (2010).

Davies, Howard and Ellis, Paul. 'Porter's *Competitive Advantage of Nations*: time for the final judgement?', *Journal of Management Studies*, vol. 37, no. 8 (December 2000).

Dunning, John H. 'Internationalizing Porter's diamond', *Management International Review*, vol. 33, no. 2 (1993).

Dunning, John H. 'The geographical sources of competitiveness of firms: some results of a new survey', *Transnational Corporations*, vol. 5, no. 3 (December 1996).

Enright, Michael J. 'The location of activities of manufacturing multinationals in the Asia-Pacific', *Journal of International Business Studies*, vol. 40 (June/July 2009).

Gao, Gerald Yong, Tan Wang, Danny and Che, Yi. 'Impact of historical conflict on FDI location and performance: Japanese investment in China', *Journal of International Business Studies* vol. 49, no .8 (2018).

Hutzschenreuter, Thomas and Gröne, Florian. 'Product and geographic scope changes of multinational enterprises in response to international competition', *Journal of International Business Studies*, vol. 40 (September 2009).

Li, Pengfei and Harald Bathelt. 'Location strategy in cluster networks', Jo*urnal of International Business Studies*, vol. 49, no. 8 (2018).

Mataloni, Raymond J. 'The structure of location choice for new US manufacturing investments in Asia-Pacific', *Journal of World Business*, vol. 46, no. 2 (2011).

Meyer, Klaus E., Mudambi, Ram and Narula, Rajneesh. 'Multinational enterprises and local contexts: the opportunities and challenges of multiple embeddedness', *Journal of Management Studies*, vol. 48, no. 2 (March 2011).

Meyer, Klaus E. and Su, Yu-Shan. 'Integration and responsiveness in subsidiaries in emerging economies', *Journal of World Business*, vol. 50, no. 1 (2015).

Moon, Hwy-Chang, Geddis, Lorna and Jin Uk Kim. 'A Fresh Look at an Old Debate on Globalization versus Localization', *Journal of Organization and Management Development*, vol. 2, no. 1 (2009).

Moon, Hwy-Chang, Rugman, Alan M. and Verbeke, Alain, 'A generalized double diamond approach to the global competitiveness of Korea and Singapore', *International Business Review*, vol. 7, no. 2 (April 1998).

Narula, Rajneesh. 'Technology, international business and Porter's "diamond": synthesizing a dynamic competitive development model', *Management International Review*, vol. 33, no. 2 (1993).

Piscitello, Lucia. 'Multinationals and economic geography: location, technology and innovation', *Journal of International Business Studies*, vol. 44, no. 8 (2013).

Prahalad, C. K. and Doz, Yves L. *The Multinational Mission: Balancing Local Demands and Global Vision* (New York: Free Press, 1987).

Porter, Michael E. 'The competitive advantage of nations', *Harvard Business Review*, vol. 68, no. 2 (March/April 1990).

Porter, Michael E. *On Competition*, updated and expanded ed. (Boston, MA: Harvard Business School Press, 2008).

Rizopoulos, Yorgos A. and Sergakis, Dimitrios E. 'MNEs and policy networks: institutional embeddedness and strategic choice', *Journal of World Business*, vol. 45, no. 3 (2010).

Roth, Kendall and Morrison, Allen J. 'An empirical analysis of the integration–responsiveness framework in global industries', *Journal of International Business Studies*, vol. 21, no. 4 (1990).

Rugman, Alan M. 'Diamond in the rough', *Business Quarterly*, vol. 55, no. 3 (winter 1991).

Rugman, Alan M. ‘Porter takes the wrong turn’, *Business Quarterly*, vol. 56, no. 3 (winter 1992).

Rugman, Alan M. and D’Cruz, Joseph. ‘The double diamond model of international competitiveness: the Canadian experience’, *Management International Review*, vol. 33, no. 2 (1993).

Rugman, Alan M. and D’Cruz, Joseph. *Multinationals as Flagship Firms: Regional Business Networks* (New York: Oxford University Press, 2000).

Rugman, Alan M. and Oh, Chang Hoon. ‘Multinationality and regional performance, 2000–2005.’ In Alan M. Rugman (ed.), *Regional Aspects of Multinationality and Performance* (Oxford: Elsevier, 2007).

Rugman, Alan M. and Oh, Chang Hoon. ‘The international competitiveness of Asian firms’, *Journal of Strategy and Management*, vol. 1, no. 1 (2008).

Rugman, Alan M., Oh, Chang Hoon and Lim, Dominic. ‘The regional and global competitiveness of multinational firms’, *Journal of the Academy of Marketing Science*, doi 10.1007/s11747–011–0270–5 (2011).

Rugman, Alan M. and Verbeke, Alain. *Beyond the Three Generics*, Research in Global Strategic Management, vol. 4 (Greenwich, CT: JAI Press, 1993).

Rugman, Alan M. and Verbeke, Alain. ‘Foreign subsidiaries and multinational strategic management: an extension and correction of Porter’s single diamond framework’, *Management International Review*, vol. 33, no. 2 (1993).

Rugman, Alan M. and Verbeke, Alain. ‘How to operationalize Porter’s diamond of competitive advantage’, *International Executive*, vol. 35, no. 4 (July/August 1993).

Rugman, Alan M. and Verbeke, Alain. *Analysis of Multinational Strategic Management: The Selected Scientific Papers of Alan M. Rugman and Alain Verbeke* (Cheltenham: Edward Elgar, 2005).

Rugman, Alan M. and Verbeke, Alain. ‘A regional solution to the strategy and structure of multinationals’, *European Management Journal*, vol. 26 (2008).

Rugman, Alan M., Verbeke, Alain and Yuan, Wenlong. ‘Reconceptualizing Barlett and Ghoshall’s classification of national subsidiary roles in the multinational enterprises’, *Journal of Management Studies*, vol. 48, no. 2 (2011).

Rugman, Alan M. and Waverman, Leonard. ‘Foreign ownership and corporate strategy.’ In Leonard Waverman (ed.), *Corporate Globalization through Mergers and Acquisitions* (Calgary: University of Calgary Press, 1991).

Stallkamp, Maximilian, Brian C. Pinkham, Andreas PJ Schotter and Olha Buchel. ‘Core or periphery? The effects of country-of-origin agglomerations on the within-country expansion of MNEs’, *Journal of International Business Studies*, vol. 49, no. 8 (2018).

Stone, Howard B. J. and Ranchhod, Ashok. ‘Competitive advantage of a nation in the global arena: a quantitative advancement to Porter’s diamond applied to the UK, USA and BRIC nations’, *Strategic Change*, vol. 15, no. 6 (2006).

Sun, Sunny Li, et al. ‘A comparative ownership advantage framework for cross-border M&As: the rise of Chinese and Indian MNEs’, *Journal of World Business*, vol. 47, no. 1 (2012).

Vahlne, Jan-Erik, Ivarsson Inge and Johanson, Jan. ‘The tortuous road to globalization for Volvo’s heavy truck business: extending the scope of the Uppsala model’, *International Business Review*, vol. 20, no. 1 (February 2011).

Yip, George S., Rugman, Alan M. and Kudina, Alina. ‘International success of British companies’, *Long Range Planning*, vol. 39, no. 2 (June 2006).

Yu, Jisun and Zaheer, Srilata. ‘Building a process model of local adaptation of practices: a study of six sigma implementation in Korean and US firms’, *Journal of International Business Studies*, vol. 41 (April 2010).

Part Four

FUNCTIONAL AREA STRATEGIES

Chapter 11

Production Strategy

Contents

Objectives of the chapter

Production strategy is critical to effective international operations. Most goods and services have very limited lives, so MNEs must continually provide new offerings, which can be accomplished only through a well-formulated production strategy. This chapter examines how MNEs carry out this

process. In doing so, we will focus on the entire range of production strategies from research and development to manufacturing, shipment, and the final international destination. We will look at the most current approaches, including speed-to-market, concurrent engineering, and continuous cost reduction.

The specific objectives of this chapter are to:

1 *Understand* how firms organise their multinational production operations.

2 *Examine* the role of research, development, and innovation in production strategy.

3 *Relate* some of the most critical steps in generating goods and services, including global sourcing, costing techniques, quality maintenance, effective materials handling, inventory control, and the proper emphasis on service.

4 *Describe* the nature and importance of international logistics in production strategy.

5 *Review* some of the major production strategies being used by MNEs, including strategic alliances and acquisitions.

ACTIVE LEARNING CASE

GE production: from Six Sigma to the GE Store

General Electric is a multibillion-dollar multinational corporation whose products range from 65 cent light bulbs to billion-dollar power plants. Based on revenues, assets, profits, and market value, the company was listed by *Fortune* magazine as number 18 in the world in 2018. One reason for GE's annual revenue of $122,274 million is its ability to manage a diverse multi product-line operation, handling such products as major appliances, lighting, medical diagnostic imaging equipment, motors, and commercial and military aircraft engines and engineering materials. As of 2017, 38 per cent of GE's revenue was from power services, 28 per cent from energy connections, 23 per cent from gas power systems, 5 per cent from steam power systems and 6 per cent from other products and services. Much of the company's success can be attributed to the production-related concepts it has employed over the last 20–30 years. During the 1980s, work-out, process mapping, and best practices were applied concepts at GE which spread to other large manufacturers.

Work-out is a training programme designed to empower employees to implement their problem-solving ideas. A group of 40 to 100 people, picked by management from all ranks and functional areas, attend a three-day meeting. The first day consists of a manager leading the group in drafting an agenda addressing areas in which productivity can be increased. Then the manager leaves and for the next few days the group breaks into teams to tackle the agenda. On the last afternoon the manager returns and one by one the team members make their proposals for improved productivity. The manager can make only three responses: agree, disagree, or ask for more information; in the last case, an individual manager must empower a team to get the information by an agreed-upon date. These work-out sessions have proved extremely successful. In one case, a group of workers convinced management to allow their factory to bid against an outside vendor for the right to build new protective shields for grinding machines. As a result, the GE group completed the job for $16,000 versus $96,000 for the vendor.

The second method, *process mapping,* is to create a flowchart that shows all the steps, no matter how small, involved in making or doing something. The map is analysed for ways to eliminate steps

and save time and money. One work group was able to reorganise production, cut manufacturing time in half, and reduce inventory by $4 million.

The third method, *best practices,* consists of finding companies that do things better than GE does and emulating them. GE personnel try to answer the question: what is the secret of this other company's success? Quite often the answer includes such things as getting products to market faster than anyone else, treating suppliers like partners, or having superior inventory management. As a result of best practices, GE is now keeping executives in their jobs for longer periods of time rather than rotating them quickly through new jobs; the best practices process revealed that frequent changes create problems in new product introductions. The company also learned how to use continuous improvement processes more effectively to bring a new product into the market ahead of the competition and then work on introducing new technologies. In the past, the firm would try to perfect all technologies first and then introduce the final product version.

In the 1990s, the dominant production concept was Six Sigma, a name that originates from a statistical method for deriving near-perfect quality, equal to 3.4 defects per million operations. The Six Sigma process allows GE to measure how many 'defects' there are in a given process and then systematically work to eliminate them to approximate 'zero defects'. Six Sigma recognises three elements: the customer, the process, and the employee. The customer is the key to defining quality. GE uses the term 'Delighting Customers' to generate a mentality whereby customer expectations of performance, reliability, competitive price, on-time delivery, service, clear and correct transaction processing, and other customer needs become a key factor in all processes. The second element, the process, promotes 'Outside-In Thinking Quality'. GE must understand the transaction life cycle from the customer's point of view and identify significant value and improvement from that same perspective. Under the banner 'Leadership Commitment People', the third element of Six Sigma, the employee, requires that all personnel use their talents and energies to satisfy customers. All employees are trained in Six Sigma, including statistical tools, strategy, and techniques of Six Sigma quality. At the core of the process is a workforce mentality on customer quality expectations, defect reduction, process capability, variation (the customer reacts to the variance rather than the average results), stability of operations, and designing processes to meet customer expectations.

GE’s advantage over other production-oriented conglomerates is its ability to transfer knowledge over the whole company. This can be attributed to former CEO Jack Welch, who oversaw GE’s transformation from a mainly manufacturing firm to a service-oriented, knowledge-based company. He defined GE’s culture by creating a workforce that can identify opportunities and implement changes.

This approach continues to the present day. In 2016, under Jeff Immelt, GE announced it would move its global headquarters to Boston (MA) as part of a structural change to improve its innovative capabilities. It aspired to become the world’s leading ‘digital industrial company’ with the aim of ‘transforming industry with software-defined machines and solutions that are connected, responsive and predictive’. GE Global Research became known as the ‘GE Store for Technology’, a global network of nine technology centres hosting 3,600 scientists and engineers, working on advanced technologies across the company’s industrial businesses. This was part of an on-going aim to structure the firm as an efficient ‘knowledge network’, developing, integrating and leveraging technological expertise across all parts of the firm to serve client needs.

Despite GE’s firm-specific advantages (FSAs) in production, it has struggled to transfer aspects of its competitive edge equally to other parts of the world. While GE used to be a home-region company with the majority of its sales in the United States, now the company is slightly more diversified, but still relatively regionally focused. For instance, in 2017 it derived 31 per cent of its revenues from the United States alone. Once its revenues from Canadian and Latin American operations are added on top of the US sales, the figure rises to nearly 42 per cent. Middle East and Africa, its largest foreign regional market, accounted for only 22 per cent of revenues, closely followed by the Asian market which accounted for 19 per cent of revenues. The remaining 17 per cent were accounted for by the European market.

Website: www.ge.com

Sources: ‘The world’s super fifty’, *Forbes*, 27 July 1998, p. 118; www.ge.com; General Electric, *10KSEC Filing*, 2002; ‘EU rejects latest GE offers’, *BBC News*, 29 June 2001; ‘EU blocks GE/Honeywell deal’, *BBC News*, 3 July 2001; ‘US Senators lash out at EU over GE deal’, *BBC News*, 15 June 2001; ‘Fortune Global 500’, *Fortune*, 2010, 2015, at

http://money.cnn.com/magazines/fortune/global500/2010/; GE, *Annual Report*, 2009, 2014, 2017; GE, 'The GE Store for Technology is open for business', 2016, http://www.geglobalresearch.com/impact/ge-store; http://fortune.com/fortune500/general-electric/, 2018; GE Annual report 2018.

1. **How did GE use work-out to increase speed-to-market?**
2. **How has GE used Six Sigma to reduce cost and improve quality in consumer goods? In each case, give an example.**
3. **In what way could best practices help GE develop more effective international strategies? Explain.**

INTRODUCTION

Production management systems underpin the creation and development of all goods and services, from hybrid cars to insurance products, internet auctions and five-star hotel operations. Just like production management in domestic firms, MNE managers are concerned with the efficient use of the many inputs into production processes, including employee skills and knowledge, equipment and facilities, all requiring continuous investment. They are also interested in investing in research and development (R&D) and in organising operations to generate successful new product lines and increase productivity and service efficiency.

Like domestic firms, MNEs need to organise their production management so they can minimise operating costs through the use of logistics and inventory control. But MNEs by their nature have a worldwide range of location options for different business functions and need to continually change the geographic distribution of subsidiaries in response to changing internal and external factors. Canon, for example, relocates production to China only if labour accounts for over 5 per cent of production costs. That way it can benefit from the lower wage levels to manufacture at lower cost. Acer, the successful Taiwanese firm, makes sure that computer parts with short product life cycles are shipped by air, and those with long product life cycles are shipped by sea (see the **Active Learning Case: Acer Taiwan goes international** in Chapter 19). However, pressures from host-country governments or special interest groups can affect a multinational's decision making in these areas. For example, host governments often criticise resource-based MNEs for their backward, forward, and horizontal integration. **Backward integration**, which is the ownership of equity assets used earlier

in the production cycle (such as an auto firm acquiring a steel company), is criticised for doing little for employment or development in the host nation. **Forward integration**, which is the purchase of assets or facilities that move the company closer to the customer (such as a computer manufacturer that acquires a retail chain that specialises in computer sales), is criticised on the basis that MNEs use the strategy to homogenise consumer tastes to the detriment of national identities. **Horizontal integration**, which is the acquisition of firms in the same line of business (such as a computer chip manufacturer that buys a competitor), is attacked for introducing similar product lines on a worldwide basis and undercutting the existence of local firms, most of which lack the economies of scale that can be achieved by MNEs.

There are similar challenges in the industrial relations area, where MNEs must take into account different labour practices and wage rates. For example, multinationals are often under pressure from host governments to use local sourcing for their supplies, hire local workers, train home-country managers and supervisors, and help improve the production environment in the host nation. These decisions can sometimes result in higher production costs, although most international auto firms, for example, use local suppliers and workers to offset this problem.

The financing of operations is another production-related challenge. The choice between local and international borrowing and the use of internally generated funds to minimise the cost of capital is complicated by foreign exchange risk, international tax laws, and government controls on capital (see Chapter 15). Additionally, MNEs need to know where they are on their production cost curves in each country, as well as globally, so as to exploit any cost advantages with an appropriate organisation structure. For example, as Toyota's worldwide market share began to stabilise, the firm found it needed to become increasingly more efficient.

The above examples illustrate some of the common production-related problems facing international firms. However, experienced MNEs have learned how to deal with these challenges. In doing so, they employ a wide gamut of production strategies that address research, development, innovation, global sourcing, costing techniques, and inventory control. The following sections examine each of these production strategies.

RESEARCH, DEVELOPMENT AND INNOVATION

Production strategies do *not* begin with manufacturing or production processes. In the past many MNEs focused most heavily on this aspect of operations, failing to realise that an effective production strategy begins with new product or service development. We need to keep in mind that many of today's best-selling products and services had not been thought of a short while ago. Many other products and services have been greatly improved over the last decade or so. Examples include cell phones, antidepressant medication, automobiles, hazardous waste treatment services, home-delivery food services, online banking, medical diagnostic equipment and televisions. MNEs have come to realise that if they are not developing new goods and services, they must be improving their current offerings. In either case the focus is on R&D and innovation.

Innovation can be broadly divided into product/service development and process development. The former refers to activities that support the creation of new products and services that customers want, or improvements to existing products/services that make more customers want them instead of those of rival firms. The latter refers to innovation activities that improve the way products/services are produced, making them quicker, cheaper or better quality. Continuous innovation lies at the heart of sustained competitive advantage, and managing it effectively has a strong international business component.

Most large firms are involved in all of these activities. Sony, for example, is continually coming up with new technology platforms (CDs, DVDs, Blu-ray, smart TVs, the PlayStation network) and new products based around

these platforms. But it also invests in improving current product lines, with new models and new features, and it strives to make them cheaper through economies of scale and continuous improvement in manufacturing.

For us, concerned with the international strategy and organisation of innovation and R&D, there are several key issues. The first is the question of how far products, services and the processes that create them should be standardised across all locations, as opposed to customising these to suit local markets. This lies at the heart of the 'integration–responsiveness' theme that runs through this book. Despite the highly standardised nature of their products, even firms like McDonald's and Coca-Cola customise these for particular markets. Like all firms, they have to manage a natural tension between country market managers who would like more customisation to suit their local customer needs and head-office managers in the marketing, operations, human resource management, R&D and strategy departments who would prefer to standardise across all markets.

A related issue is: where should firms locate different innovation-related activities? The answer to this depends on the industry and often the product or service in question. It is worth examining this by looking at the factors that influence the organisation of R&D around the firm.

MNEs tend to operate several types of R&D networks, as shown in Figure 11.1. There is an innovation hierarchy from basic, long-term or blue-sky R&D, which is often based around finding scientific breakthroughs, to applied, near-market or demand-led innovation:

- Blue-sky or basic R&D centres are often linked to universities or government research institutes to tap into highly specialised expertise, wherever it is in the world.
- Technical design and development centres focus on more practical, near-market R&D and may be separate or co-located with regional headquarters or major business units.

- Applied technical development and customisation departments, often situated within manufacturing centres, will focus on incremental improvements to production processes or minor adaptations to products to suit local markets.

Home country-based central R&D often sets the overall R&D strategy across a firm, but funding and other resources may partly come from country market managers who will push for more applied R&D activities to adapt products and services for their markets. For a large MNE, a few key locations may have R&D units, the firm's main markets may all have one or more applied R&D centres and production locations will have technical centres. The complexity of managing strategy and implementation up and down the innovation hierarchy and across the different country locations should not be underestimated.

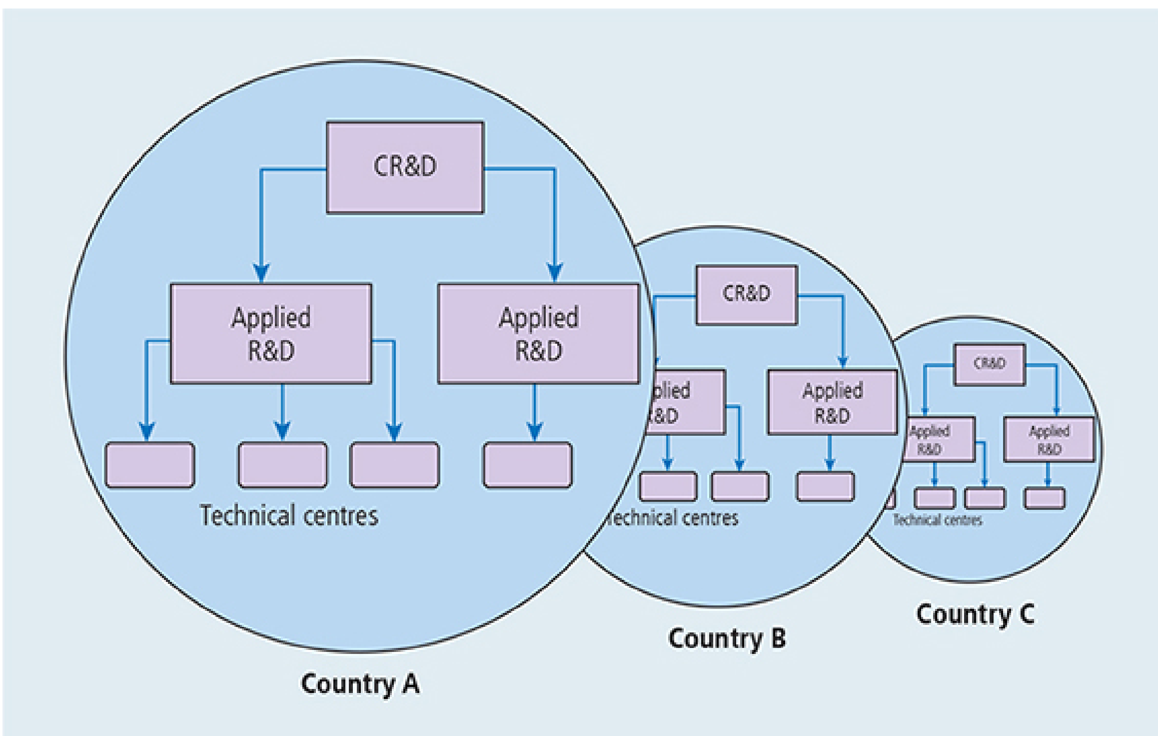

Figure 11.1 Global R&D: markets and hierarchies

In terms of both product and process development, MNEs need to prioritise country locations according to both (1) local market requirements in terms of adaptation, design and development, and engineering support, and (2) local technological resources, expertise, contract companies, universities, and so on, often called the 'national system of innovation'.

The above organisation structures are important because they affect how well firms leverage their R&D efforts for competitive advantage. The efficiency with which specialist knowledge inputs from experts around the firm are coordinated is paramount. For example, firms have to focus new product development (NPD) efforts at the point where technological opportunities meet market opportunities. Marketing departments and subsidiaries, distributors and retailers in country markets understand customer needs, whereas the central R&D department and technical design and development centres around the firm understand the potential of various technologies. These areas of specialist knowledge have to combine efficiently to direct NPD, and this is often done within cross-functional teams. NPD project teams are continually created and disbanded in manufacturing and service firms in response to the ever-changing technological and market opportunities they are faced with, and the strength of internal and external networks determines how well firms manage this process.[1]

Large MNEs that are good at managing knowledge networks are in a better position to leverage the scale and scope advantages that put them ahead of smaller or domestic market firms in terms of their innovativeness. They can afford large (scale) and specialist (scope) centres of excellence and can manage joint ventures with other big players to pool resources and spread the risk of R&D projects. They can then link these R&D centres to their markets around the world, prioritising areas of development on which to focus their efforts to reap the most rewards in terms of sales of new and improved products.

Global innovation management and knowledge management are seen to be increasingly important to the long-run performance of all firms. Nohria and Ghoshal use the terms *distributed innovation* and *differentiated networks* to characterise how firms should learn globally and exploit this learning globally to improve production processes and products in all markets.[2] Other studies also emphasise the internal processes, within multinational structures, that constrain or facilitate this kind of global capability.[3]

Speed-to-market

One of the major manufacturing challenges facing MNEs is the speed with which they develop and get new products to market. In recent years, many firms have found that a 'speed-to-market' strategy can be extremely profitable. Table 11.1 provides some data to support this statement. Notice that a company that enters the market one month ahead of the competition can increase annual gross profits by $150,000 on a product that generates $25 million and $600,000 on a product that generates $100 million. Simply put, by carefully designing the product and getting it out of the door fast, the company can dramatically increase profitability.

MNEs have taken a number of steps to ensure early delivery of their products. For example, Cisco Systems has outsourced the production of routers and switches to Flextronics, a contract electronics manufacturer. Flextronics receives an electronic order from Cisco, manufactures the product under the Cisco brand, and then delivers it directly to the customers. BMW has combined engineering, development and production planning in bringing new cars to market in record time.

Table 11.1 The cost of arriving late to market (and still being on budget)

If the company is late to market by:					
6 months	5 months	4 months	3 months	2 months	1 month
Gross potential profit is reduced by:					
233%	225%	218%	212%	27%	23%
If time-to-market is improved, profit will go up by:					
11.9%	9.3%	7.3%	5.7%	4.3%	3.1%
For revenues of $25 million, annual gross profit will increase by:					
$400,000	$350,000	$300,000	$250,000	$200,000	$150,000
For revenues of $100 million, annual gross profit will increase by:					
$1,600,000	$1,400,000	$1,200,000	$1,000,000	$800,000	$600,000

Source: *Academy of Management Executive*, 'The New Competitors: They Think in Terms of 'Speed-to-Market', by Joseph T. Vesey © 1991 The Academy of Management (NY).

The strategic emphasis is on increasing speed by developing **time-to-market accelerators**, which are factors that help reduce bottlenecks and errors and ensure product quality and performance. These accelerators vary from firm to firm, but they all produce the same results: to increase the speed of production output while also increasing the quality output, producing less waste and maintenance and fewer customer returns or complaints.

In the past, many MNEs placed the bulk of their production attention on the manufacturing side of the operation. However, recent research shows that the best way to reduce defective products and speed delivery is by placing the greatest attention on product design and planning of operations. This is accomplished through what is known as **concurrent engineering**, which involves design, engineering, and manufacturing people working together to create and build the product. Concurrent engineering is useful for two reasons. First, if the product is carefully designed, fewer changes are needed later on and the good can be brought to market swiftly. Second, the costs associated with changes increase as the product gets closer to completion; that is, it is almost twice as expensive to correct a problem during production as during product design.

Once a product or service has been planned out, the MNE’s attention turns to production. This strategy is focused very heavily on minimising costs and increasing quality and productivity.

✔ Active learning check

Review your answer to Active Learning Case question 1 and make any changes you like. Then compare your answer to the one below.

1 How did GE use work-out to increase speed-to-market?

The primary way GE used work-out to increase speed-to-market was by looking for ways to eliminate production bottlenecks and streamline operations. The strategy of work-out asked the participants: how can we change the operation to get more done in less time? The workers who were familiar with the operations often had a wealth of information to share, and this was sometimes the first time anyone had asked them for their opinions. They were delighted to offer suggestions and recommendations. As a result, the company produced more products in less time than ever before.

GENERATION OF GOODS AND SERVICES

Most people think of the production process as one in which physical goods are produced. However, the process can also be used in generating services, and the two are quite often interlinked. For example, GM manufactures cars but also offers auto maintenance and repair services, whereas Boeing both builds and services aircraft. In other cases, services are primary, such as the Hilton Corporation offering hotel accommodations, Hertz and Avis leasing cars and CNN providing international news coverage.

Sometimes goods and/or services are provided directly by the MNE; at other times the MNE has an arrangement with outside firms or suppliers (some of them being direct competitors) to assist in this process. For example, other firms make some of the HP printers, but HP has its name put on the units and assumes responsibility for marketing them. Service organisations follow a similar strategy. Some airlines purchase their in-flight food from companies like Marriott, and some rely on aircraft maintenance firms such as Ryder to service their craft. Many motels subcontract their food service to companies that specialise in this area, including fast-food franchisors such as McDonald’s and Burger King. So there is often a mix of product/service strategies at work when generating goods and services. The following discussion examines some of the most important functions that are carried out in this process. The production of goods is emphasised most heavily because some of the areas under discussion do not lend themselves to services – although one that does is global sourcing, a primary area of consideration in production strategy.

Global sourcing

Sometimes MNEs produce all the goods and services they need. However, they often use **global sourcing** by calling upon those suppliers which can provide the needed output more efficiently regardless of where they are geographically located.

Global sourcing has become important for a number of reasons. The most obvious one is cost. If GM wants to be price competitive in the European Union, one strategy is to build and ship cars from Detroit to Europe at a price equal to, or less than, that charged by EU competitors. Because this is not possible, GM uses overseas suppliers and assembly plants to build much of what it sells in Europe. In deciding who will provide these parts and supplies, the company uses global sourcing, as do other MNEs.

Not all global sourcing is provided by outside suppliers. Some MNEs own their own source of supply or hold an equity position in a supplier. This relationship does not guarantee that the supplier will get the MNE's business on every bid. However, if the supplier is unable to match the cost or quality performance of competitive suppliers, the MNE will eventually terminate the relationship. So there is a great deal of pressure on the supplier to develop and maintain state-of-the-art production facilities. Additionally, because the supplier works closely with the MNE, the company knows how its multinational client likes things done and is able to operate smoothly with the MNE's design and production people.

In recent years, some giant MNEs have taken equity positions in a number of different suppliers. Japanese multinationals are an excellent example. These firms often have a network of parts suppliers, subcontractors and capital equipment suppliers they can call on.

At the same time these suppliers often provide goods and services to other firms. This helps them to maintain their competitive edge by forcing them to innovate, adapt, and remain cost effective. If these suppliers are in similar or complementary industries, as in the case of NEC's suppliers, then

technological innovations or revolutionary changes in manufacturing processes will be quickly accepted or copied by others. So the close proximity of the suppliers coupled with their business relationships helps to ensure that they attain and hold positions as world-class suppliers, and this advantage carries over to the customers, who gain both innovative ideas and high-quality, low-cost supplies.[4]

A good example is the leather footwear industry in Italy. Manufacturers regularly interact with leather suppliers, designers and producers of other leather goods. As a result, the manufacturers are extremely knowledgeable about industry technology, production techniques, fashion trends and supply sources.

These advantages also help explain why many US suppliers are going international. By setting up operations near world-class competitors, these suppliers find it easier to monitor developments, remain alert to changes in technology and production processes, and maintain state-of-the-art facilities. In fact, when manufacturers expand operations to another country, it is common to find their major suppliers setting up operations nearby in order to continue serving the manufacturers. The other reason is to prevent local competitors from capturing some of this business, which often happens when the supplier attempts to compete from the home country.

The global clothing industry provides a good example of these trends. The production of clothing sits within a broader value chain, which includes textiles and fibres for a range of both household and industrial goods. Upstream, the textile industry relies on access to sources of natural fibres, a ‘natural’ factor endowment in Porter’s diamond of advantage, compared to the ‘acquired’ factor endowments associated with the chemicals industry for the production of artificial fibres. Clearly, each has favoured different countries at different stages of the industry’s development. Downstream, distribution and retailing and, in particular, branding and marketing have

remained predominantly within the major markets of industrially advanced countries (and under their ownership). The case **International Business Strategy in Action: H&M learning from Zara** illustrates these patterns.

INTERNATIONAL BUSINESS STRATEGY IN ACTION

H&M learning from Zara

Founded in 1947, the H&M Group is a Swedish retail clothing organisation that has grown to encompass stores in 69 markets across the world. In 2017, approximately 171,000 people were employed by H&M Group, which achieved revenues of almost $25 billion. The Group's portfolio consists of eight clearly defined brands: H&M; COS; Monki; Weekday; & Other Stories; Cheap Monday; H&M Home; and ARKET. Together these brands offer customers a plethora of different styles and trends in fashion, beauty, accessories and homewares. Importantly, although each brand possesses its own unique identity, these brands complement each other well, allowing the H&M Group to exploit synergistic benefits.

Despite the fact that H&M is one of the world's most successful clothing retail groups, profits decreased sharply, by approximately 20 per cent, in the third quarter of 2018. Unusually, this decrease did not correlate with a decline in sales; the Swedish multinational actually saw a 9 per cent increase in its revenue, largely assisted by a 32 per cent rise in online sales. The rise of the internet has shifted traditional shopping habits to an online platform, resulting in retailers across the world experiencing a lower footfall, and in turn, a decline in in-store sales. Given that clothing retailers have been struggling to cope with online competition, H&M were heavily engaged in a strategy to improve their online presence in markets across the world. For instance, the H&M brand alone has an online presence in in 47 markets, and the H&M Group is reported to be working hard to make sure that their products are available in more online markets. Table 11.2 illustrates the number of markets in which H&M operates online.

Table 11.2 H&M stores and markets in 2017

Brand	Number of stores	Number of markets with stores	Number of markets online
H&M	4,288	69	43
COS	231	37	20
Weekday	33	9	18
Monki	119	14	19
Cheap Monday	3	2	18
H&M Home	**	46	37
& Other Stories	60	16	15
Arket	5	4	18

**H&M Home is present in 46 markets with shops-in-shops in 332 of H&M's stores and two H&M Lab stores.

Source: H&M Annual Report 2017.

H&M Group's decline in profits was actually attributable to its heavy investment in the implementation of a new logistics system, which sought to advance their logistics to provide consumers with a better online experience. However, H&M experienced difficulties in rolling out the new system, with a range of teething problems reportedly costing the organisation around $43 million. This not only required immediate investment to fix the issue, but also resulted in a reduction in sales in affected markets. Initially, the new logistics system was introduced in the US, France, Italy and Belgium, which in turn were most affected by this logistics issue. This difficulty in rolling out a new system is a classic example of a retailer inaccurately forecasting consumer spending, resulting in a warehouse full of stock, and inventories piling up and profits shrinking, amid rising opportunity costs. However, despite initial difficulties, the system was central to H&M's attempt to make their global supply chains more efficient and faster, while improving their ability to be more agile and resilient to market change.

Arguably, H&M learns a great deal from its main rival, Zara, which produces approximately 450 million products per year. The capability of Zara to cope with such large volumes is partly due to their strategy of owning and managing their global supply chains in-house. What makes Zara stand out from its competition is the small-batch deliveries it makes twice a week to all of its stores around the world, all of which are achieved with clockwork accuracy. Essentially, Zara's business model and operations have synergistic benefits; growth is achieved through the management of a diversified portfolio of products, supported by the firm's vertically integrated supply chain. Zara is able to design, manufacture and distribute its products to stores within two weeks of appearing on the catwalk, clearly outperforming rivals which require six months for the same procedure. Zara's global business model is the epitome of fast fashion and given the ability of the firm to execute these operations, it is easy to assume that this is solely due to a simplified supply chain, but this is not the case. The complexity is demonstrated in Figure 11.2, which presents the journey of a single Zara

dress which goes through Austria, Egypt, China, Spain, Morocco and back to Spain, before finally being moved to one of Zara's retail stores in any of its 92 global markets.

One of the practices that Zara rigorously utilises to achieve fast fashion is 'just-in-time' production. Made famous by Toyota and a number of other large Japanese manufacturers in the 1980s, the underlying philosophy behind this strategy is to control and receive products and materials 'just-in-time', to reduce costs and stocks. The key to Zara's success also lies in keeping a large proportion of its production in-house, with factories allowing for 85 per cent of their capacity for seasonal adjustments, providing flexibility and the ability to respond to consumer demand. Given that the majority of manufacturing takes place in-house, Zara is able to be relatively flexible in the amount, frequency and variety of new products to be launched, in comparison to rivals who are reliant on external firms to drive their supply chains.

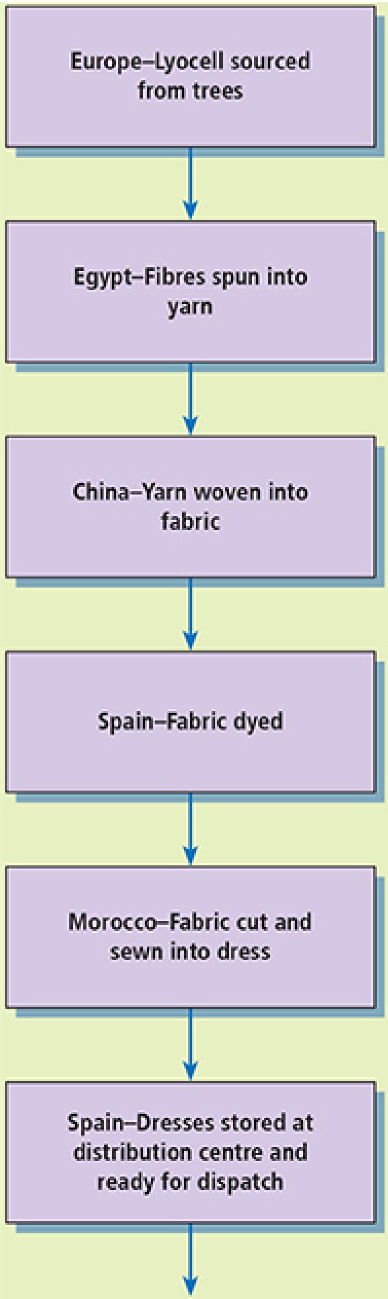

Figure 11.2 The journey of a single Zara dress

Source: BBC (2017).

In conclusion, H&M's business model emphasises fast fashion and quality at a reasonable price. In conjunction with this, as they offer a varied product range, H&M makes it easy for consumers who are fashion conscious to express their own personal style, allowing the brand to attract consumers across a wide demographic. H&M is making greater efforts to attract and maintain an

online customer base all over the world, while improving the efficiency of their global supply chains to enhance the customer experience and maintain growth. However, in order to truly embody the idea of fast fashion, H&M would need to vertically integrate their global supply chains, following in the footsteps of Zara, giving them total control of their operations and reducing dependencies on external suppliers that have the ability to disrupt business.

Sources: https://www.independent.co.uk/news/business/news/hm-sales-online-profit-swedish-fashion-brand-asos-zalando-a8558226.html; https://www.cips.org/en-GB/supply-management/news/2018/october/problems-with-logistics-system-rollout-cost-hm-34m/; https://www.forbes.com/sites/marioabad/2018/11/08/hm-moschino-collaboration-designers/; https://www.tradegecko.com/blog/zara-supply-chain-its-secret-to-retail-success; https://fashionunited.uk/news/business/h-m-boosts-online-sales-as-profits-plunge/2018092739171; https://www.bbc.co.uk/news/business-39337204; H&M Annual Report (2017).

The clothing industry itself can be subdivided into three activities: design, preparation and production. The last two have remained relatively labour intensive, which is why most preparation and production are done in cheap-labour locations. China's share of world exports in clothing grew from 4 per cent in 1980 to over 20 per cent in 2014, and it is now the world's dominant exporter. Over 5 million Chinese are employed in the sector. By contrast, the United States has the biggest trade deficit in clothing.[5] Scotland and Italy, two dominant forces in textiles and clothing at one time, for example, have shifted upmarket to specialise in design and high-quality/fashion items. Employment has fallen drastically in these countries as a result and the patterns of trade have also reversed.

When MNEs turn to global sourcing, there is typically a hierarchical order of consideration. The company gives first preference to internal sources, such as having subassemblies produced by the manufacturing department or the subsidiary that specialises in this work. However, if a review of outside sources reveals a sufficient cost/quality difference that would justify buying

from an external supplier, this is what the company will do. In fact, sometimes an MNE will not attempt to make a particular part or product because it lacks the expertise to do so efficiently. The firm will simply solicit bids from outside suppliers and award the contract based on predetermined specifications (price, quality, reliability, delivery time, etc.). This has been analysed as the '**make or buy decision**'; whether to 'internalise' production of a part of a product or service within the firm's boundaries, or to 'externalise' by contracting another firm to produce it. Nobel prizewinning economist Oliver Williamson framed this as a trade-off between 'hierarchies' (firms) or markets in his theory of transactions cost economics. The degree of complexity and uncertainty attached to a particular contract (transaction) were key factors to take into account in both Williamson's analysis and the related studies of Edith Penrose on why firms 'do what they do' and leave other things to the market.[6]

Environmentalists and social responsibility experts have focused the global supply chains of MNEs. The former are concerned with how global sourcing may be less sustainable, particularly in terms of the high use of energy in transporting goods around the world. The latter are concerned with the ethics of some firms' supplier relationships, particularly when MNEs contract smaller suppliers in less-developed economies and low cost is only possible through exploitation of (or maintaining unequal power relations with) low-wage employees.

Some firms face high risks due to their significant dependence on global outsourcing. Outsourcing to suppliers may open up opportunities for competitors. Similarly, outsourcing production to different suppliers may prevent the development of new insights, innovations and solutions which typically require cross-functional teamwork. Finally, outsourcing may risk key knowledge leakage.

Manufacturing of goods

MNEs face a variety of concerns in manufacturing goods and services. Primary among these are cost, quality and efficiency in production systems.

Cost

Multinationals seek to control their costs by increasing the efficiency of their production processes. Often this means using new, improved technology such as state-of-the-art machinery and equipment, and/or higher-skilled employees. Both require ongoing investment, but raising productivity through lower costs is key to maintaining competitive advantage. A good example is provided by the automobile industry in Brazil, which is the heart of the South American automobile market. Firms including as Volkswagen, Fiat, Ford, General Motors, Nissan Motors, Toyota, Mercedes-Benz, Renault, Honda, Hyundai and the Chinese firm BYD are based there, producing over 2 million cars per year. **Modular manufacturing** allows suppliers of parts to take on some of the assembly. Dana Corporation, which has set up shop near a Chrysler factory in the city of Curitiba, is now responsible for the assembly of the Dakota's basic skeleton, which represents approximately 30 per cent of the total cost of production. Once this skeleton reaches Chrysler, it is mounted with an engine and a body. Entire assembly lines had to be rebuilt to accommodate this process. Volkswagen, Ford and General Motors are also developing similar assembly plants to test their efficiency for future implementation to their other factories.

A second approach is to faucet low-cost labour sources. A good example is the *maquiladora* industry (as discussed in Chapter 10) that has sprung up in Mexico just across the US border. Hundreds of US plants have been established in this area. Examples include TRW Inc., which has a factory where workers assemble seat belts, and Mattel, which has a plant where workers turn out Barbie-doll houses and Disney teething rings. Labour costs

in these facilities are less than 20 per cent of those of similar workers in the United States. Also, because this is a free trade zone, US duties are levied on the imports only to the extent of the value added in Mexico, so low wage rates in Mexico help keep down the import duty.

INTERNATIONAL BUSINESS STRATEGY IN ACTION

Magna International Inc.

Magna International is a Canadian-based auto parts and mobility technology company. From humble beginnings, Frank Stronach opened a single store called Multimatic in 1950s Toronto. Since then, what is now Magna International Inc, has grown into the largest North American automotive parts company with sales of $38.9 billion in 2017 and in 2016 was the third largest in global sales, behind industry giants Robert Bosch GmbH and ZF Friedrichshafen AG.

During the 1960s Multimatic expanded within Canada, exceeding a million dollars in annual sales, by gaining its first supply contract with General Motors. Its expansion was made easier through the US and Canadian Auto Pact of 1965, opening up trade between the two countries by removing tariffs on automobiles and automobile parts. By the end of the decade the company exceeded $100 million in sales, and a merger between Multimatic and Magna Electronics Limited created Magna International. The 1970s was a decade of diversification, expanding production to its first US facility, growing its products and headquartering in Toronto, Ontario. At the end of the 1980s the company had continued its expansion, surpassing the one billion dollars in sales for the decade.

In the 1990s Magna went global, opening its first plant in Mexico and expanding in Europe through acquisitions of automotive suppliers. It became a publicly traded corporation in 1992 and finished the decade with over $9 billion in sales. Into the new millennium, Magna expanded both geographically and in terms of its product portfolio, through strategic acquisitions. During the decade, sales surpassed $20 billion and Magna became the biggest auto-parts company in North America. In 2002 it acquired Donnelly Corporation, diversifying its exterior and interior mirror and lighting product range. Magna continued its global expansion, opening its first two plants on the African continent.

After a slow-down in global automobile production, 2010 saw continued expansion and strong investment in new technology and innovation. As shown in Figure 11.3, Magna International has become a globally networked company. In 2018, Magna had over 168,000 employees spread across

335 manufacturing operations and 96 manufacturing operations, product development, engineering and sales centres (PDE&S) in 28 countries.

A key driver of this expansion, was the 2015 acquisition of Getrag International GmbH for $1.9 billion. The company is a leader in the independent supply of automotive transitions and has over 14,000 employees worldwide. Getrag's 80-year history and world leading status allowed Magna to enhance its powertrain systems. A rapidly growing market globally, this is a crucial component for the reduction of fuel consumption and emission production. This move bolstered Magna's position in the powertrain component market, broadening its geographical reach and customer base. Getrag's sales are forecast to double from 2014 level of $3.5 billion, to an estimated $7 billion by 2019 with China representing a huge growth market, increasing from 10 per cent of 2014 revenues, and rising rapidly to 50 per cent by 2019.

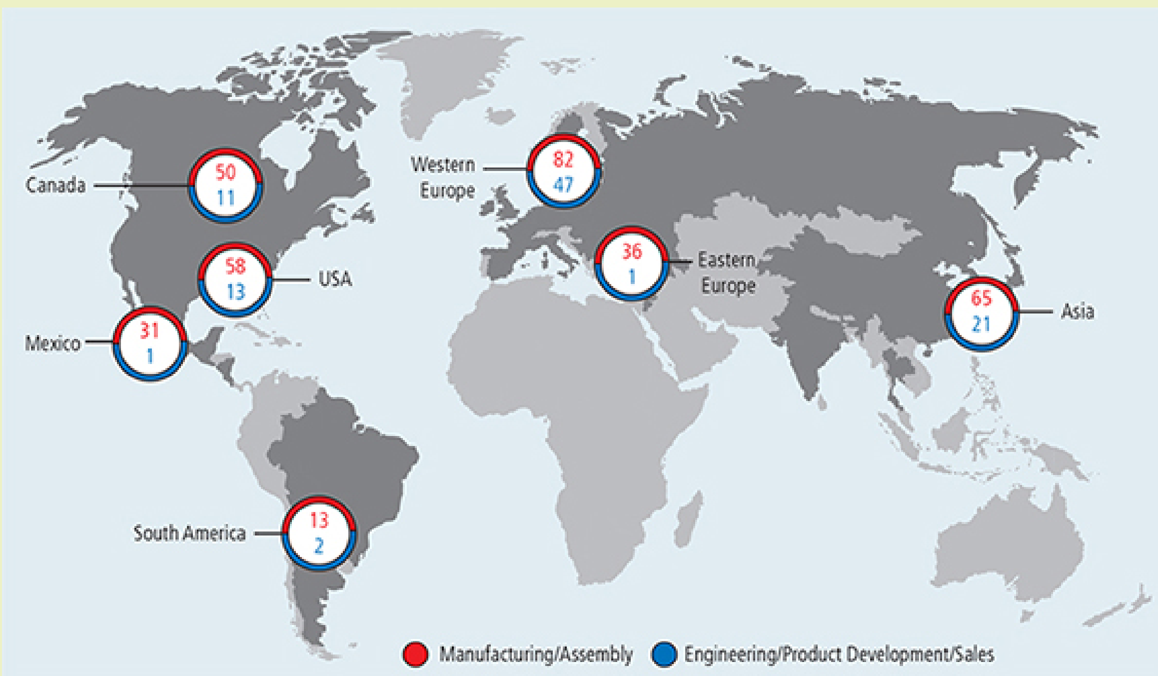

Figure 11.3 Magna's global operations

Magna is continuously innovating and expanding to keep up with the turbulent global automotive industry. In 2018, Magna announced a strategic partnership with the ride-hailing company Lyft. They have partnered to develop and manufacture self-driving systems to be used on the Lyft network and to the wider auto market. Lyft will take the lead on development of the system, while Magna

will be responsible for manufacturing the system. The partnership includes a $200 million investment into Lyft and is part of their long-term strategy for autonomous solutions with sensing technologies. Magna has also invested an additional $82 million in technology companies to develop scalable solutions for autonomous driving systems.

Although Magna has continued its global expansion with revenue growth across all of its main customers (see Table 11.3), it has not all been straightforward. After benefiting from the 1965 US and Canadian Auto Pact, in 2019 the US added tariffs of 25 per cent on steel and 10 per cent on aluminium. With 25,000 employees in the US, 23,000 in Canada and 28,000 in Mexico, Magna is especially vulnerable to NAFTA disagreements and tariffs. Magna estimated that the US tariffs could cost them $45–50 million in 2019 and had already resulted in a $30 million hit in the past two quarters.

Table 11.3 Magna's aggregated external revenues by customer

	2017	2016
General Motors	$ 6,854	$ 7,207
Ford Motor Company	6,058	5,667
Fiat/Chrysler Group	5,502	5,349
Daimler AG	4,719	4,294
BMW	4,231	3,786
Volkswagen	4,025	3,758
Other	7,557	6,384
	$38,946	$36,445

Websites: http://www.magnaannualreport.com/pdf/SEDAR_AIF_20180328.pdf; http://www.magnaannualreport.com/pdf/SEDAR_MDA_and_FS_Magna_v3.pdf; https://www.cbc.ca/news/business/magna-international-reports-fourth-quarter-profits-1.5029504; https://www.magna.com/company/company-information/facts-history/our-history; https://www.theglobeandmail.com/report-on-business/magna-to-buy-germanys-getrag/article25526592/; https://blog.lyft.com/posts/lyft-x-magna-to-scale-self-driving-technology; https://www.wsj.com/articles/magna-to-buy-transmission-maker-getrag-1437052261

Sources: Sturgeon, T., van Biesebroeck, J. and Gereffi, G., 2009. 'The North American automotive production system: Canada's role and prospects', *International Journal of Technological Learning, Innovation and Development*, 2, pp. 25–52. Sweeney, B.A. and Mordue, G.D. (2017) 'The Restructuring of Canada's Automotive Industry, 2005–2014', *Canadian Public Policy*, 43 (S1), pp. S1–S15.

A third approach is the development of new methods used to cut costs. For example, it is typical for a firm to calculate the selling price at an early stage in the new product development process. If the price is judged to be too high, the product is sent back to the drawing board to be reworked, or the company moves on to another project.

A fourth method that is gaining popularity with MNEs is that of costing products not on an individual basis but as part of a portfolio of related goods. Instead of evaluating the expenses of developing one new soft drink, for example, a company looks at the costs and revenues associated with the entire line of beverages. Coca-Cola of Japan provides an example. Every year it introduces more than 1,000 new soft drinks, fruit drinks and cold coffees into the Japanese market. Ninety per cent of them fail, but this does not stop Coca-Cola from introducing approximately one new product a month. From a cost accounting standpoint this is not a profitable strategy. However, as one Coca-Cola executive in Japan puts it, 'We know that some of these products will survive only a month or two, but our competitors have them, so we have to have them.' As a result, Japan is Coca-Cola's most profitable market and the company sells a variety of non-carbonated drinks to complement its main brand.

Quality

Quality has always been one of the major criteria for business success. The 'customer is king' and maintaining sales depends on maintaining a reputation

for quality products and services. Nowhere is this more clearly reflected than in the auto industry, where the Japanese have garnered a large share of the international market by using what is called *kaizen*, or continuous improvement (see Chapter 17). A good example is Toyota Motors, which has continually worked to reduce costs and improve quality. One way Toyota has achieved this goal is partly through large R&D expenditures. Another is through meticulous design, engineering and production processes that ensure a proper fit of all parts and overall durability of the unit. US and European auto manufacturers caught up with the Japanese some time ago, partly by imitating some of the above processes.

Other excellent examples of MNEs that have succeeded because of a strong focus on quality include such lesser-known firms as Stanley Works, the WD-40 Co. and A. T. Cross. Stanley Works manufactures tape measures in Asia then has the accuracy of samples checked by sophisticated laser computers back in New Britain, Connecticut, before selling them worldwide. Stanley has also developed a host of other high-quality products, from double-toothed saws that cut on both the upstroke and the down-stroke for the Asian market, to hammers without claws for carpenters in central Europe (who prefer to use pliers to pull out bent nails), to levels shaped like elongated trapezoids, which the French market prefers.

The WD-40 Co. of San Diego manufactures WD-40, a water-displacing lubricant that fights rust, cleans heel marks from linoleum and walls, and provides a variety of other services around the house. Car mechanics use it to loosen sticky valves and remove moisture from balky carburetors; odd jobbers apply it to frozen locks and screws. Today the blue-and-yellow spray-can is found in stores throughout the world, where it enjoys fanatical customer loyalty.

Value chains and production systems

A **value chain** is a group of related activities designed to create value in a product or service sold by a firm. This value can be embedded in a physical product, like a programmable timer on a washing machine which allows the user to change the length of individual wash-runs. Or it can be a feature that comes as part of a service, like a 'free' breakfast added to a hotel room booking or discounted hospital bills as part of a health insurance package.

A **production system** relates to the physical system, comprised of skilled employees, equipment and facilities which combine to create goods and services, including layout, materials, handling processes.

Location

Location is particularly important in the context of international business, because MNEs gain competitive advantage by managing value chains (portfolios of business activities) worldwide, changing the location of different parts of production systems to exploit changing prices or availability of materials, labour skills, technology or knowledge sources, or the growth and decline of customer markets. They can reduce costs or improve quality, or innovate more effectively by re-locating certain activities in particular places.

MNEs also need respond to changes in national and local government policy. Some provide tax breaks or other financial incentives to encourage them to set up operations, particularly when these create employment. Accompanying considerations include the availability and cost of labour, raw materials, water and energy, as well as the development of the country's transportation and communication systems. As noted earlier, many suppliers set up operations near their major customers. For example, Ford has built up an integrated production network in western Europe. Ford suppliers are part of this production network so as to maintain their business relationship. Starbucks (see Figure 11.4) also acknowledges the importance of location and has primarily set up processing plants in close proximity to its coffee

plantation sites. Location is also important to service enterprises because they usually require face-to-face contact with their customers. Hotels and airlines are typical examples. Personal service firms such as those of accountants, lawyers and management consultants also fall into this category.

Layout

Plant layout is important because of its impact on efficiency. For example, most auto producers use an assembly line layout in which the workers remain at their station and, as the cars move past them, perform the necessary functions such as installing radios, air-conditioners, interior trim, and so on. In the case of Volvo, the employees work in small teams to build an entire car and the plant is laid out to accommodate this work flow. In other manufacturing settings, however, worldwide competitive firms tend to use U-shaped-cell flow lines, which are more efficient. Schonberger, an internationally known manufacturing expert, has noted that U-shaped production designs enable one person to tend several workstations and increase the speed at which materials can be delivered and defective parts can be reworked. Finally, Maytag has chosen to combine different layouts to cater to each production line in just one factory. A traditional long conveyer belt assembly line makes its standardised models. A second area makes more sophisticated models in smaller production cells instead of a long line. The third area makes the most sophisticated machines. In this setting, workers are craft workers putting together a substantial part of the machine.

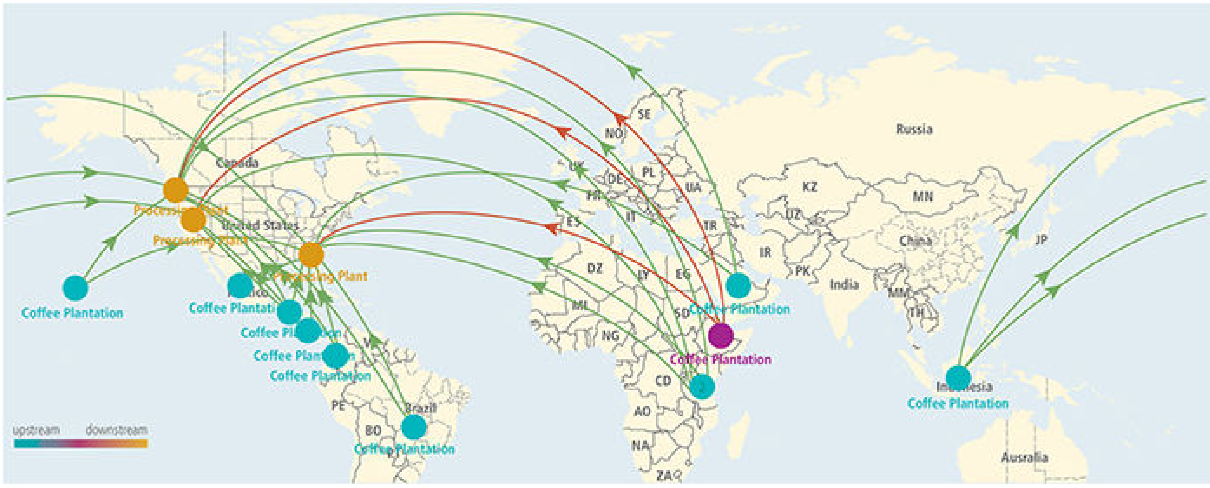

Figure 11.4 **Where Starbucks gets its coffee**

Layout varies widely in service organisations, although it appears to be universal in use. Most hotels, regardless of the country, have the check-in and check-out areas in the same place as such support groups as the bellhops, concierge and cashier. In fast-food units, the food preparation area is situated so that the personnel can quickly serve both in-unit and drive-through customers.

Material handling

Material handling involves the careful planning of when, where and how much inventory will be available to ensure maximum production efficiency. Part of this is resolved through careful inventory control processes. Part of it is handled when the production layout is determined. For example, General Electric uses **process mapping**, a flowchart that shows every small step in producing a product. As a result, the company is able to study every part of an operation and determine those that are redundant or that can be streamlined. Consequently, the company has been able to reduce work time on some jobs by as much as 50 per cent.

Inventory control

Inventory control has received a great deal of attention in recent years because a well-designed inventory strategy can have dramatic effects on the bottom line. One of the most popular concepts has been **just-in-time inventory (JIT)**, which is based on delivering parts and supplies just as they are needed. If this concept were carried to the extreme, it would mean that manufacturers would not need to store materials because suppliers would be delivering them just in time for shipment to the factory floor.

JIT is an important concept that has been adopted by MNEs throughout the world. However, the degree of use varies based on the product and the company's production strategy. In some companies it is used simply to keep inventory to a minimum. In more advanced firms, like one of the pioneers of the approach, Toyota, the concept is taken further and applied to link supply and demand in real time. Dealers order directly from the factory, which means that customers can get their built-to-order car in 7 to 10 days.

One of the major problems with JIT is that its success rests heavily on the quality and reliability of the suppliers. In Japan, where MNEs often have an equity position in these companies, suppliers will go out of their way to meet partners' demands. However, in the United States and Europe, most suppliers are independent businesses that work under a contract relationship, so the bonds are often not as strong between the two parties. A second problem with JIT is that, although it works well in managing delivery of parts to the assembly line, few firms have been able to apply the concept to the entire production process. Most firms still manufacture and ship their output to dealers to sell, in contrast to Toyota's approach of matching supply and demand before producing. One of the most important things to remember about JIT is that it needs strong support from the workers and the suppliers. Everyone must be operating in unison. If the workers are slow, there will be excess inventory on hand; if the supplier is late, the workers will be sitting by idly.

Demand-Flow™ Technology (DFT) is a production process that allows for flexible changes in the middle stages of production. Typically used to produce standardised assembly products, such as computers, DFT permits quick reactions to changes in demand and technology. A surge of demand for Intel processors used within computers, for instance, would immediately shift inputs from other computers to be combined with processor chips to respond to demand. This virtually eliminates inventories. Intermec, a company that makes bar code scanners, mobile computers and related products, reduced inventory by 50 per cent after implementing DFT. It was also able to consolidate five different printer lines into one flexible mixed-model line, decreasing the amount of required manufacturing floor space by 20 per cent.

Developing a strong service orientation

As noted earlier, many products have a service element associated with them. Sometimes this element is more important than the product itself. For example, many people will not purchase a car or home appliance unless it can be serviced easily. Service is also important when choosing a bank, insurance agent, lawyer or doctor. Many of the ideas we have discussed in this section, including sourcing, cost and quality, are also key factors in shopping for services. In addressing this area, MNEs will do two things: (1) consider whether their strategy needs to be oriented towards a product, a service or a combination of the two; and (2) determine the ideal degree of service to provide.

Determining the product/service balance

Some outputs lend themselves to a strong production orientation, whereas others require much more attention to service. Figure 11.5 offers an illustration. Designed more as a point of reference than as a factual source that addresses every firm in the respective industry, the figure nonetheless shows

that some MNEs need to have a strong product-dominated focus whereas others benefit most from a service orientation. A good example is offered by aircraft manufacturers that must be concerned with both ends of the continuum. Olympus and Pentax, both manufacturers of flexible endoscopic equipment, provide another example. To develop their brand names in Latin America, these companies offer medical professionals the surgical training necessary to use their equipment. Because after-sales service is also an important consideration for prospective buyers, including hospitals, all major endoscope manufacturers have service stations in the region.

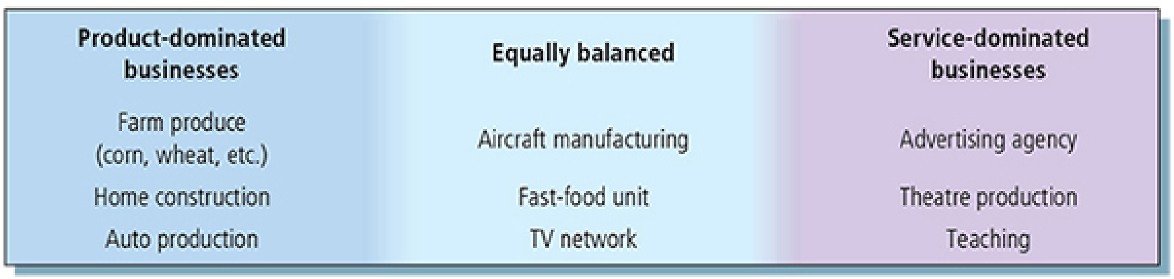

Figure 11.5 Product- and service-dominated businesses

On the other hand, some manufactured products require far less service than they used to need. A good example is photocopiers. Manufacturers of these machines have improved product quality so substantially that many units are now sold on the basis of price. Service is no longer a major factor because everyone's product is of such high quality.

Knowing whether to sell on the basis of product or service (or a combination of the two) is critical to the success of many MNEs. A mistake at this point can result in emphasis on the wrong sales factors.

Providing the right amount of service

Once the MNE has determined the proper balance of product and service domination, it evaluates the specific type of service warranted. This is particularly important because many MNEs find that the strategy used in their

own country does not work overseas. A good example is the Japanese approach to retail services. The amount of personal service provided in Japan would surprise many Westerners. For example, auto dealers typically provide pick-up and delivery for repair service customers and make new car sales calls to customers' homes. In department stores, it is common to find executives and sales clerks alike lined up to bow to the first customers in the store. Japanese banks often help their customers sell or buy homes, find distributors for merchandise and provide them with tax advice.

Although these services help Japanese companies maintain customer satisfaction, research has found that they are of little value to doing business in other countries. For example, Japanese banks in the United States have discovered that US customers want only a limited amount of quality service; they prefer quantity and efficiency in the form of a variety of different services offered at low prices. As a result, Japanese banks here offer the same types of services as do other US banks. Would they be more successful if they changed this strategy and tried to emulate the approach used back home? Given the nature of the US market, they believe this would be a mistake. The lesson is clear: when competing in terms of service, one must match the competition but not exceed it unless the customer is willing to pay for this service. In the United States, the banking customer is not willing.

Active learning check

Review your answer to Active Learning Case question 2 and make any changes you like. Then compare your answer to the one below.

2 How has GE used Six Sigma to reduce cost and improve quality in consumer goods? In each case, give an example.

Six Sigma allows GE to use process mapping to reduce cost by identifying those activities that can be eliminated or combined in the production process. For example, can an individual who is performing one assembly-line task take on other tasks and thus reduce the number of people needed to produce the product? Can inventory be ordered and delivered in smaller amounts, thus making greater use of just-in-time? Consideration of these types of questions can help reduce cost. In improving product quality, the work group can examine how well all parts of the product fit together, examine the durability of the unit, and look for additional ways of testing the product to ensure that it measures up to quality standards.

INTERNATIONAL LOGISTICS

International logistics is the designing and managing of a system to control the flow of materials and products throughout the firm. This includes the inflow of materials, movement through the production process and outflow to the wholesale/retail firm or final consumer. International logistics is an important area of strategic consideration because these expenses can account for 10 per cent of the total costs. The material management aspect of international logistics has already been addressed. The following discussion examines three other key topics: transportation, packaging and storage.

Transportation

In examining international logistics, we focus on the primary modes of transportation: ocean and air. The others – rail, pipeline and motor carrier – are of importance in some regions (such as the European Union), but they are not as commonly used in moving goods from an MNE's plant to their final destination. Moreover, their use is highly dependent on the infrastructure of the country – that is, how extensive, costly, congested and well-kept are the nation's road system and rail network.

Ocean shipping

International firms can choose from a fairly wide variety of ocean carriers. The three most common carriers are conventional **container ships**, cargo vessels and **roll-on-roll-off (RORO)** vessels. Container ships are used to carry standardised containers that can be simply loaded onto the carrier and then unloaded at their destination, without any repackaging of the contents of the containers. A carrier similar to the RORO is the **lighter aboard ship**

(LASH) vessel, which consists of barges that are stored on the ship and lowered at the point of destination. These individual barges can then operate on inland waterways.

Air shipping

Most countries have airports that can accommodate air freight. The problem with this mode of transportation is its high cost. Thus, although international air freight has grown dramatically over the last 30 years, it still accounts for less than 1 per cent of the total volume of international shipments. It is used in trade more commonly among industrialised nations than any others, and it is usually restricted to high-value items that must reach their destination quickly.

Several developments have occurred over the past couple of decades that have helped increase the use of air shipments. These include more efficient ground facilities, larger aircraft and better marketing of these services to shippers. In particular, the development by aircraft manufacturers of jumbo cargo jet planes and combination passenger and cargo aircraft has helped immensely.

Choice criteria

In deciding the best transportation mode to use, MNEs tend to focus on four important criteria: time, predictability, cost and non-economic factors.

Time

The period between departure and arrival of a carrier can vary significantly between an ocean freighter and an aircraft. So one of the questions a firm must answer is: how quickly is delivery needed? A number of factors can influence the answer. One is the perishability of the product. Exotic flowers from South America are flown to the United States because they would not survive a sea voyage. A second factor is how soon the goods are needed to

replenish current stocks. Autos from Japan are brought into the United States by ship because the length of the trip does not hurt the supply of cars on hand at local dealerships.

In businesses where speed is critical, companies are now coordinating their worldwide supply chains in order to reduce the amount of time needed to get the goods through the production cycle and to the customer. Victor Fung, Honorary Group Chairman (previously CEO) of Li & Fung, Hong Kong's largest export trading company and an innovator in the development of supply-chain management, has provided an example of how this is being done:

> Say we get an order from a European retailer to produce 10,000 garments. It's not a simple matter of our Korean office sourcing Korean products or our Indonesian office sourcing Indonesian products. For this customer we might decide to buy yarn from a Korean producer but have it woven and dyed in Taiwan. So we pick the yarn and ship it to Taiwan. The Japanese have the best zippers and buttons, but they manufacture them mostly in China. Okay, so we go to YKK, a big Japanese zipper manufacturer, and we order the right zippers from their Chinese plants. Then we determine that, because of quotas and labor conditions, the best place to make the garments is Thailand. So we ship everything there. And because the customer needs quick delivery, we may divide the order across five factories in Thailand. Effectively, we are customizing the value chain to best meet the customer's needs. Five weeks after we have received the order, 10,000 garments arrive on the shelves in Europe, all looking like they came from one factory, with colors, for example, perfectly matched.[7]

Predictability

Although both air and water transportation are basically reliable, they are subject to the vagaries of nature. Bad weather can close an airport; inadequate seaport facilities can slow the loading and unloading of cargo. Because of the great difference in delivery time between the two modes, the choice is often obvious. If a company needs to have a package delivered tomorrow, it will

come by air; if the firm wants to clear merchandise out of the warehouse today but the international customer does not need it for 90 days, it will be sent by water. However, certain carriers are more reliable than others, and the MNE will use its experience in determining which companies to choose for delivery. Reliability is particularly important for air shipments, where a difference of one day could significantly influence the saleability of the product.

Cost

The expense associated with shipping is a major consideration when choosing an international transportation mode. Because air freight is significantly more expensive than shipment by water, the cost must be economically justifiable. Typically, an MNE will use air shipments only when time is critical and/or the product has high value. For example, if the company has purchased expensive watches in Zurich for its specialty outlets in New York and San Francisco, the watches will be flown to the retailers. On the other hand, if the merchandise is bulky or the cost of air freight is a significant portion of the value of the product, it will be sent by water. Autos are exported by ship, as are bulk commodities and resources such as oil and coal.

Packaging

Packaging is important in ensuring that a product is shipped in a safe container and arrives undamaged. When goods are transported a long distance or to areas with climates different from the one where they are manufactured, the container can prevent spoilage or leakage. Chemicals, for example, must be carefully sealed in containers that can withstand impact and will not crack open if tipped over or dropped. Machines, such as personal computers, must have interior packing that prevents damage during transit.

Packaging is also important because of its direct effect on cost. If units must be shipped in odd-shaped containers, fewer of them can be loaded into the hold of the transport than if they are shipped in square or rectangular containers and can be loaded atop and alongside each other. The weight of the packing material is also important, especially when goods are being shipped by air and costs are based on both distance and weight.

Packaging is also important in reducing loading and unloading costs and minimising theft and pilferage. In recent years many shippers have begun using **intermodal containers**, which are large metal boxes that fit on trucks, railroad trains and aircraft, and help cut handling costs and theft losses by placing the merchandise in an easy-to-move unit that is tightly sealed.

Storage

In some cases, goods that are shipped internationally have to be stored before being moved to their final destinations. In the United States, public storage is widely available. In other countries, including Japan, warehousing facilities are in short supply. Additionally, the configuration of many warehouses is different from that in the United States. Ceilings are often lower and there is little automation for handling such common chores as loading and unloading packages or stacking containers on top of each other. In such cases, the MNE must decide whether to invest in warehouse facilities or ship goods only when needed, thus eliminating the warehouse function.

As discussed in Chapter 6, some countries have **foreign trade zones**, which are areas where foreign goods may be held and processed and then re-exported without incurring customs duties (same as a free trade zone). These zones are usually found at major ports of entry (including international air terminals). Their effective use can help an MNE: (1) temporarily store its goods while breaking a large shipment into smaller ones to be shipped to other locales; (2) combine small shipments into larger ones and then reship

them; (3) process the goods and perform a host of value-added activities before repackaging them for the market; and (4) give those goods that will remain in the local market a 'made in' status so that they can be sold as locally produced products.

An effective storage strategy can be particularly helpful in carrying out the final stages of an MNE's production plan. The strategy can also help minimise overall product cost, reduce delivery time and increase customer satisfaction.

DIFFERENT KINDS OF GLOBAL PRODUCTION SYSTEMS

Location is a key factor in deciding the global structure of firms' production systems. But it needs to be considered alongside other factors which vary considerably by industry.

Companies tend to focus on the functions and innovation activities where they have the major advantage and often outsource activities, or parts of the value chain where they add less value. This determines the 'boundaries' of the firm, what activities are internalised, and what are externalised or left to other firms to provide on a contract basis (see Endnote 6). Figure 11.6 shows a number of example industries and firms that have very different global production systems, determined by the functions and activities that add the most value.

Although Intel does a lot of marketing, its main competitive advantage lies in the continual development of new semiconductors, the heart of PCs and other IT and electronic devices. Product and process development are internalised and highly centralised because this suits the type of technology and product that the firm focuses on. At one point it accounted for around 25 per cent of all R&D investment in the semiconductor industry. Much of its high-value manufacturing, particularly wafer production and fabrication, is done in the United States, where most of its manufacturing workforce is based. Other production sites are in Dalian (China), Israel and Ireland. Much of its labour-intensive assembly and testing takes place in Malaysia, the Philippines, China and Costa Rica, but is owned by Intel (internalised).

Production system / Where is the value added?	Internalized (within the firm's hierarchy)	Mixed	Externalized (to other firms in the market)
R&Dltechnology	Example: semiconductors (Intel)		Example: telecoms (Ericsson)
Manufacturing		Example: autos (Toyota)	
Marketing			Example: clothing (Gap)

Figure 11.6 Global production systems: where is the value added?

Source: Adapted from UNCTAD, *World Investment Report*, 2002.

Ericsson also keeps much of its research, design and development activities within the firm, but not so long ago it decided to let other firms make many of the components that make up its telecom systems. The large Singaporean firm, Flextronics, took over much of Ericsson's manufacturing and supply-chain activities in Brazil, Malaysia, Sweden and the UK (See **Real Case: Flextronics** at the end of this chapter). It externalised these activities because it decided they were not part of its core competencies, and it could safely contract other firms to supply these components.

Gap Inc. and other clothing firms have externalised the manufacturing function for many years now. Their focus is clothing design, marketing, branding and real estate management. There are enough producers in cheap labour locations (such as China, which exports more garments than any other country by far) for Gap to use the market to contract out this activity to the cheapest and/or best. Intermediaries in this industry, like Flextronics in telecoms, include Mast Industries and Li & Fung.

Toyota lies in the middle of these two extremes. Because manufacturing, and particularly maintaining continuous improvement in manufacturing, is so central to its competitive advantage, Toyota is partly vertically integrated

down the supply chain. New product development (new car models and features) and process development (improving price and quality) are closely linked and involve good relationships with (and/or ownership of some) component suppliers. It cannot externalise car production because it is the source of many of its core competitive advantages.

Finally, for diversified or multiproduct firms, configuring the right kind of global production system can get complicated. Philips, for example, makes semiconductors, like Intel, but also has large consumer electronics and consumer products divisions. It has to manage both technology-driven and market-driven innovation and production activities.

STRATEGIC MANAGEMENT AND PRODUCTION STRATEGY

MNEs are currently focusing on a number of areas in improving their production strategies. Three that are getting particular attention are (1) technology and design, (2) continuous improvement of operations, and (3) productivity benchmarking.

Technology and production design

MNEs are now spending more money on R&D than they have in the past. This is particularly the case for pharmaceutical firms, such as Roche (19 per cent) and Merck (over 25 per cent), software firms like Alphabet (just under 15 per cent) and social media firms like Facebook (almost 20 per cent) as well as some technology hardware developers, like Intel (over 20 per cent). Yet, R&D is not only developing new products, but also helping firms find alternative parts as well as production techniques. A second current trend is the use of concurrent engineering, which was discussed earlier in the chapter. Many MNEs are now realising that a team approach to product development, which combines the talents of research, design and manufacturing people as well as customers and clients, results in a more successful product.

Coupled with these strategies are innovative human resource development programmes that are designed to improve the engagement and skills of employees, so they are better able to innovate in radical and/or incremental ways. For some firms, **empowerment**, which involves giving employees greater control over their workflow and encourages employee/team-led improvement initiatives, helps increase creativity and innovativeness.

Continuous improvement

Due to the success of Japanese MNEs, *kaizen* (continuous improvement) has been emulated by MNEs worldwide. No matter what the good or service is, every day the company tries to do the job better. Some consultants have referred to this strategy as 'rapid inch-up', which certainly captures the essence of the concept. US firms in particular have benefited from this idea. This dominated thinking in manufacturing, led by automotive firms in the 1980s and 1990s, when Toyota and Honda were able to offset the rising value of the yen with cost saving in their factories, thus allowing them to hold the price line on many of their new cars. These innovations were adopted in other manufacturing plants in other countries and are now generic in manufacturing and many service sectors.

Productivity

National governments as well as firms are interested in productivity. Benchmarking productivity levels across national economies provides insights into how efficient and productive the overall economy is, using measures such as aggregate output per hour, output per job and output per worker across a range of industries and regions. A common measure of labour **productivity** is **Gross value added (GVA)** per unit of labour (employee), used to compare firms or countries. Among the G7 countries, Japan has the lowest level of productivity and Germany the highest. The US is better than average and the UK is near the bottom of this ranking, with 16 per cent less than the G7 average.

Total factor productivity (TFP) is another measure used particularly to examine the efficiency of manufacturing plants. It is defined as the proportion of output not explained by the amount of inputs used in production and indicates how efficiently the same, given set of inputs are used in different production processes. It also tends to focus on innovation and higher-level

management skills as key factors for deriving better efficiency and more value from a given set of inputs.

Manufacturing firms actively benchmark themselves against other firms using various measures of efficiency, productivity, quality, safety and sustainability. They also benchmark internally, comparing different manufacturing plants in different locations around the world to see which is the most productive. This provides some of the best insights into the influence of location-specific factor endowments (or country-specific advantages; CSAs), such as labour skills, transport infrastructure and local supply chains, as described in Chapter 10 and the Porter Diamond.

Active learning check

Review your answer to Active Learning Case question 3 and make any changes you like. Then compare your answer to the one below.

3 In what way could best practices help GE develop more effective international strategies? Explain.

Best practices could help GE develop more effective international strategies by encouraging it to benchmark specific plants, functions or processes against those of successful competitors. Key indicators of success might be speed-to-market with new products, high-quality output (fewer customer complaints or returns), lowest-cost products or more efficient production systems. What accounts for their ability to achieve such an excellent performance? By asking and answering these questions, GE can gain insights into how it needs to change its own production processes in order to emulate those MNEs successfully.

KEY POINTS

1. Many of today's goods and services will be replaced in the future with faster, more efficient and cheaper substitutes. For this reason, MNEs need to continually research, develop and bring new offerings to the marketplace. One way this is being done is through the use of time-to-market accelerators. A good example is concurrent engineering.
2. The generation of goods and services entails a number of specific functions. One is obtaining materials or supplies. Many MNEs have found that global sourcing is the best strategy because it helps keep down costs while providing a number of other benefits, including ensuring an ongoing source of supply and helping the company penetrate overseas markets.
3. In the production of goods and services, MNEs focus on a number of key factors, including cost, quality and well-designed production systems. While these three factors are often interrelated, each merits specific attention. Multinationals have also developed very effective inventory control systems that help minimise carrying costs and increase productivity. Attention is also focused on gaining the proper balance between production and service domination.
4. International logistics is the designing and managing of a system to control the flow of materials and products throughout the firm. In addition to inventory control, this involves transportation, packaging and storing.
5. MNEs are currently focusing on a number of areas in improving their production strategies: (1) technology and design; (2) continuous improvement of operations; and (3) productivity benchmarking.

Key terms

- **backward integration**
- **forward integration**
- **horizontal integration**
- **time-to-market accelerators**
- **concurrent engineering**
- **global sourcing**
- **make or buy decisions**
- **modular manufacturing**
- **value chain**
- **production system**
- **material handling**
- **process mapping**
- **just-in-time inventory (JIT)**
- **Demand-Flow™ Technology (DFT)**
- **international logistics**
- **container ships**
- **roll-on-roll-off (RORO) vessels**
- **lighter aboard ship (LASH) vessels**
- **intermodal containers**
- **foreign trade zones**

- **empowerment**
- **productivity**
- **Gross value added (GVA) per head**
- **Total factor productivity (TFP)**

REVIEW AND DISCUSSION QUESTIONS

1. Why are MNEs so interested in new product development? Why do they not simply focus on improving their current offerings?
2. Why is speed-to-market such an important production strategy? Explain.
3. What are time-to-market accelerators? In what way is concurrent engineering one of these accelerators?
4. Why do many MNEs use global sourcing? Why do they not produce all the parts and materials in-house? Be complete in your answer.
5. Why are world-class suppliers often located next to world-class manufacturers? What forms of synergy often exist between the two groups?
6. How do MNEs try to cut production costs? Identify and describe three steps.
7. In what way is the continuous reduction cost method used by Japanese manufacturers different from the periodic cost reduction method employed by many US firms? Compare and contrast the two.
8. Some MNEs use a production strategy that involves costing a portfolio of related goods rather than just costing each individually. What is the logic behind this strategy?
9. How does *kaizen* help bring about increased quality? Is this approach limited to Japanese firms or are other MNEs using it as well?
10. What types of issues does an MNE confront when it seeks to improve its production system? Identify and describe three.
11. How does JIT help an MNE control its inventory? Give two examples.
12. How is employee training an important factor in implementing JIT and DFT production processes?
13. Why would an MNE want to determine the degree to which its primary business was product dominated and service dominated? Explain.
14. Why are MNEs concerned with international logistics? How does this help the companies increase their competitiveness?

15 In recent years MNEs have been focusing on a number of areas in improving their production strategies. What are two of these? Identify and describe each.

REAL CASE

Flextronics

You wouldn’t think that company rivals such as Sony and Philips, or Ericsson, Alcatel and Motorola, would choose to share the same factories to build competing products, but that is just what has been happening since the emergence of electronics manufacturing service providers (EMSPs). Contract manufacturing was a trend that changed the face of electronics manufacturing. Companies unknown to the public, such as Flextronics, Foxconn, Sanmina-SCI, Celestica and Jabil, among others, now make such well-known products as IBM PCs, the Microsoft Xbox video console, Web TV set-top boxes for Philips and Sony, and portable phones for Ericsson, Alcatel and Motorola. In 2006, EMSP industry revenues were estimated at over $200 billion and by 2013 they exceeded $1 trillion. In 2007 two of the largest EMSP companies, Flextronics and Solectron, combined when Flextronics, with revenues of $18.8 billion, acquired Solectron, with revenues of $10.6 billion. But this is a fast-moving industry sector and by 2015 Flextronics had slipped to fourth place in terms of revenues, behind the giant Hon Hai Precision industries, parent company to Foxconn and the main supplier to Apple, with revenues of almost $40 billion. In 2016, the largest European EMSPs were Foxconn, Flex and Jabil, who together controlled approximately 44 per cent of the $34.5 billion market.

Flextronics remains one of the *Fortune* Global 500 (ranked 466) companies in 2017, but most end-customers who use its products have never heard of it. Incorporated in Singapore in 1990, Flextronics is a provider of vertically integrated advanced design and electronics manufacturing services (EMS) to original equipment manufacturers (OEMs). It provides these services to various markets, which include infrastructure, mobile communication devices, computing, consumer digital devices, industrial, semiconductor capital equipment, clean technology, aerospace and defence, white goods, automotive and marine, and medical devices. As of 2018, approximately 80 per cent of all of Flextronic’s manufacturing was located in low-cost locations, including Brazil, China, Hungary, India, Indonesia, Malaysia, Mexico, Poland, Romania and the Ukraine. In total, in 2018 Flextronics’ total manufacturing capacity was approximately 28 million square feet. The company helps customers design, build, ship and service electronics products through a network of over 100 facilities in 30 countries across four continents, and it has been recorded as employing

approximately 200,000 employees. Though officially headquartered in Singapore, the company has strong ties to the US market and most of its customers are US companies. Flextronics is listed on NASDAQ (the United States) and the Frankfurt Stock Exchange (Germany).

Over the years Flextronics has expanded by purchasing smaller EMSP contractors and factories from its customers. In 2001, Flextronics purchased half of Xerox's office equipment-making operations for $220 million. The deal came with a five-year outsourcing contract for Flextronics to manufacture Xerox products. Currently its ten largest customers, including Sony-Ericsson, Motorola and Hewlett-Packard, account for about 64 per cent of net sales from continuing operations. In 2018, Flextronics' total revenue was $25.4 billion. It generated 44 per cent of its sales from Asia, 39 per cent from the Americas, and 17 per cent from Europe.

Source: Ingemar Magnusson/Alamy Stock Photo

Because of lower transportation costs as a percentage of total value, electronics can be transported by air, whereas cars are always transported by sea. This is one main reason why contract manufacturing has been so successful in the electronics industry, where parts might travel the world over before the product is finished.

Prior to the merger with Solectron, Flextronics had six industrial parks in low-cost regions near each large triad market. In Asia, two industrial parks in China, one in Malaysia and one in India, and

a network of regional manufacturing facilities, supply printers, cell phones, telephone switching boards and PDAs, among other products. In the Americas, products from its two industrial parks (one in Mexico, one in Brazil) and its network of manufacturing facilities include automotive, telecommunications, networking equipment and hardware products, among others. In eastern Europe, Poland and Hungary host two industrial parks and Ukraine one park, which are also supported by nearby manufacturing facilities and produce telecommunications infrastructure, electronics for automotives, printers and disposable cameras, among other items.

The choice of location for production facilities is determined by the quality of the labour force, the cost of producing in the country and the proximity to a triad market. Mexico, for example, is the low-cost region in the North American market. Brazil has the best industrial capabilities among countries in South America and strong ties to large international firms from Europe and North America. China has abundant labour, high expected economic growth and proximity to the large Japanese market where international firms like Canon, NEC and Sony are headquartered. Eastern Europe is the low-cost production area for western European markets. It is no surprise that the Flextronics industrial park in Poland is located near a university from which it can acquire skilled labour. EMSPs do much more than provide cost-effective manufacturing. They help in the design of products to make them easier to manufacture; they also provide logistics services, such as material procurement, inventory management, vendor management, packaging and distribution, and automation of key components of the supply chain through advanced IT. In addition, they offer after-market services such as repair and warranty services.

Today's electronic manufacturers have come a long way from the cheap labour-based contractors that used to dominate the industry. Robotic automation is now a significant part of the production process and is handled mostly by specialists. It is their manufacturing expertise that makes for lower costs, but EMSPs provide many more advantages to OEMs. They decrease the risk of manufacturing because OEMs no longer need to make large investments in a new factory to create a new product that might or might not be successful. EMSPs can also purchase inputs at lower prices because they are making cell phones not only for Alcatel, but also for Motorola and Ericsson, increasing their purchasing power.

Contract manufacturing accounts for almost half of electronic manufacturing and this proportion has grown steadily since the early days of Flextronics. EMSP companies will increasingly dominate the industry in the future and this process will redefine the role of OEMs in the electronics industry as one of design and marketing.

Website: http://hardwarebee.com/top-25-electronics-manufacturing-service-providers-ranking-europe-2016/; http://fortune.com/global500/flex/

Sources: Karyn McCormack, 'Flextronics adds a key part', *Business Week*, 4 June 2007; 'Let the bad times roll', *The Economist*, 5 April 2001; Jonathan Sprague, 'Invasion of the factory snatchers', *Fortune*, 15 August 2002; Flextronics, *Annual Report*, 2010, 2014; Alan M. Rugman, *The Regional Multinationals* (Cambridge: Cambridge University Press, 2005); Flex Annual Report 2018.

1 Keeping in mind that Flextronics does not sell to end-customers, how does that change your interpretation of the regional sales data presented in this case?

2 What effect does the emergence of EMSPs have on new entrants into the electronics industry?

3 Why should OEMs be concerned about using EMSPs?

REAL CASE

Nike

One of the rules of international production strategy is: manufacture the highest-quality product and the world is likely to beat a path to your door. A number of firms help illustrate this rule. One is Nike, the sports shoe and clothing producer. Making a wide variety of high-quality shoes, Nike catalogues more than 800 models for use in approximately 25 sports. In 1999 it had 35 per cent of the world's market for training shoes (and 45 per cent in the United States) and these relative proportions have surprisingly not changed much. In 2017 its sales were $34.35 billion and it employed 73,100 employees. In an effort to keep ahead of the competition, Nike updates each shoe at least every six months. Most of these ideas are generated by Nike's R&D centre in Beaverton, near Portland, Oregon, where physiologists and mechanical engineers study the stresses on an athlete's feet and collaborate with stylists on new shoe ideas. Moreover in 2018, Nike is reported to sign a $144 million deal with in one of China's (Chinese League of Legends) sporting competitions, which will cover clothing, accessories and shoes.

The aim of the takeover of Umbro on 3 March 2008 was to extend these scale advantages. Although Nike sells its products in over 140 countries and produces in more than 33 countries, it is really a triad MNE. In 2018, 43 per cent of Nike's revenue was generated in the United States, 27 per cent from Europe, Middle East and Africa, and 30 per cent from Asia (including China) Pacific and Latin America. Sales in the United States including US sales of other businesses accounted for approximately 43 per cent of total revenues, which is remarkably consistent compared to 43 per cent in 2008. It has maintained a steady share of the global market and has remained focused on its core home market.

Nike's high-quality production is matched by superb marketing skills. The world might be beating a path to Nike's door, but the company makes sure the world knows where it is. It has been reported that Nike spends 11 per cent of its revenue on marketing, and its 'swoosh' brand is recognised the world over. The company continues to use sports stars to endorse its products and is responsible for some of the biggest athlete endorsement deals of all time, including sponsorship of Michael Jordan and LeBron James. A deal for James in 2015 was worth an estimated $30 million,

but brought in over $340 million for Nike through the launch of a line of branded sneakers. Besides American stars like Tiger Woods it has used European soccer players, such as Cristiano Ronaldo, and cricket players in India. The idea is: if you can make the 'cool' guys wear your products, the rest will follow.

Perhaps the only thing Nike does not like to be remembered for is the bad publicity around its labour practices in Asia. Nike has outsourced all of its production to low-wage areas. By 2018, Nike supplied their goods from 452 factories (124 footwear factories and 328 apparel factories) and virtually all of Nike footwear was being produced by contract factories in Vietnam, China, Indonesia, Thailand and India. Nike also had manufacturing agreements with independent factories in Argentina, Brazil, Mexico and India to manufacture footwear for sales within those countries. In addition, all its apparel was produced in 33 host countries by independent contract manufacturers. Most of the apparel production occurred in China, Thailand, Indonesia, Malaysia, Vietnam, Sri Lanka, Turkey, Cambodia, El Salvador, Mexico and Taiwan. And NGOs have criticised the poor working conditions in some of its Asian factories, from Pakistani children stitching Nike's soccer balls, to Vietnamese working in unsafe conditions. NGOs in the Western world started campaigns to boycott Nike, and demonstrators protested in front of Nike's stores. Allegations of long working hours, bad ventilation and physical abuse of a mostly young female workforce have raised questions about Nike's reputation.

Nike's industry dominance was a main reason for its being severely targeted. Many of its competitors were found to have the same labour practices, but were not subjected to the same level of criticism. More recently Nike has acknowledged its corporate responsibility to improve working conditions in its own factories and help influence its suppliers.

Website: www.nike.com

Sources: Sydney H. Schanberg, 'On the playgrounds of America, every kid's goal is to score: in Pakistan, where children stitch soccer balls for six cents an hour, the goal is to survive', *Life*, June 1996; Harry Dunphy, 'Nike to improve conditions', *Associated Press*, 12 May 1998; Tom Braithwaite, 'Nike moves closer to deal for Umbro', *Financial Times*, 21 December 2007; Nike, *Annual Report*, 2009, 2010, 2015, 2017; Total Sportek, 'Biggest athlete endorsement deals in sports

history', 2016, http://www.totalsportek.com; http://www.sportspromedia.com/news/nike-league-of-legends-pro-league-sponsorship-deal.

1 What is the key to Nike's production strategy? Explain.

2 What are the advantages of frequent design changes in Nike's sneakers?

3 Why was it important for Nike to clean up its labour practices in Asia? What more should the company do?

NOTES

1 Simon C. Collinson, ‘Knowledge management capabilities in R&D: a UK–Japan company comparison’, *R&D Management*, vol. 31, no. 3 (2001), pp. 335–47.
2 N. Nohria and S. Ghoshal, *The Differentiated Network: Organizing Multinational Corporations for Value Creation* (San Francisco, CA: Jossey-Bass, 1997).
3 T. W. Malnight, ‘Emerging structural patterns within multinational corporations: toward process-based structures’, *Academy of Management Journal*, vol. 44, no. 6 (2001); and M. T. Hansen and B. Løvås, ‘How do multinational companies leverage technological competencies? Moving from single to interdependent explanations’, *Strategic Management Journal*, vol. 25, no. 8/9 (2004).
4 Michael E. Porter, *The Competitive Advantage of Nations* (New York: Free Press, 1990), p. 103.
5 https://www.usitc.gov/research_and_analysis/trade_shifts.htm
6 Oliver E. Williamson, *Markets and Hierarchies: Analysis and Antitrust Implications* (New York: Macmillan Publishers, 1983). Edith Penrose, *The Theory of the Growth of the Firm* (New York, John Wiley and Sons, 1959).
7 Joan Magretta, ‘Fast, global, and entrepreneurial: supply chain management, Hong Kong style: an interview with Victor Fung’, *Harvard Business Review* (September/October 1998), pp. 105–6.

BIBLIOGRAPHY

Abdollahi, Mohammad, Arvan, Meysam and Razmi, Jafar. ‘An integrated approach for supplier portfolio selection: lean or agile?’, *Expert Systems with Applications*, vol. 42, no. 1 (2015).

Ambos, Björn and Schlegelmilch, Bodo B. ‘The use of international R&D teams: an empirical investigation of selected contingency factors’, *Journal of World Business*, vol. 39, no. 1 (February 2004).

Andersson, Ulf, Dasí, Ángels, Mudambi, Ram and Pedersen, Torben. ‘Technology, innovation and knowledge: The importance of ideas and international connectivity’, *Journal of World Business*, vol. 51, no. 1 (2016).

Awate, Snehal, Larsen, Marcus M. and Mudambi, Ram. ‘Accessing vs sourcing knowledge: A comparative study of R&D internationalization between emerging and advanced economy firms’, *Journal of International Business Studies*, vol. 46, no.1 (2015).

Belderbos, René, Lokshin, Boris and Sadowski, Bert. ‘The returns to foreign R&D’, *Journal of International Business Studies*, vol. 46, no. 4 (2015).

Bellak, Christian and Cantwell, John. ‘Revaluing the capital stock of international production’, *International Business Review*, vol. 13, no. 1 (February 2004).

Bhuiyan, Nadia and Baghel, Amit. ‘An overview of continuous improvement: from the past to the present’, *Management Decision*, vol. 43, no. 5 (2005).

Castellani, Davide, Montresor, Sandro, Schubert, Torben and Vezzani, Antonio. ‘Multinationality, R&D and productivity: Evidence from the top

R&D investors worldwide', *International Business Review*, vol. 26, no. 3 (2017).

Cantwell, John. 'Innovation and information technology in the MNE.' In Alan M. Rugman and Thomas Brewer (eds.), *The Oxford Handbook of International Business* (Oxford: Oxford University Press, 2001).

Chan, Jenny, Pun, Ngai and Selden, Mark. 'The politics of global production: Apple, Foxconn and China's new working class', *New Technology, Work and Employment*, vol. 28, no. 2 (2013).

Choi, Jeongho and Contractor, Farok, J.. 'Choosing an appropriate alliance governance mode: The role of institutional, cultural and geographical distance in international research & development (R&D) collaborations', *Journal of International Business Studies*, vol. 47, no. 2 (2016).

Chou, Yon-Chun, et al. 'A framework of economic analysis for tapered technology-manufacturing alliances', *International Journal of Production Economics*, vol. 127, no. 2 (2010).

Collinson, Simon C. 'Organizing knowledge to manage R&D: a UK–Japan company comparison', *R&D Management*, vol. 31, no. 3 (2001).

Contractor, Farok J., Kumar, Vikas, Kundu, Sumit and Pedersen, Torben. *Global Outsourcing and Offshoring: An Integrated Approach to Theory and Corporate Strategy* (Cambridge: Cambridge University Press, November 2010).

Contractor, Farok J., Kumar, Vikas, Kundu, Sumit K. and Pedersen, Torben. 'Reconceptualizing the firm in a world of outsourcing and offshoring: the organizational and geographical relocation of high-value company functions', *Journal of Management Studies*, vol. 47, no. 8 (December 2010).

Curran, Louise and Zignago, Soledad. 'How regional is the supply chain in the enlarged EU?', *Multinational Business Review*, vol. 18, no. 1 (2010).

Cusumano, Michael A. ‘Manufacturing innovation: lessons from the Japanese auto industry’, *Sloan Management Review*, vol. 30, no. 1 (fall 1988).

Dyer, Jeffrey H. and Chu, Wujin. ‘The determinants of trust in supplier–automaker relationships in the US, Japan, and Korea’, *Journal of International Business Studies*, vol. 42 (January 2011).

Frost, Tony S. and Zhou, Changhui. ‘R&D co-practice and ‘reverse’: knowledge integration in multinational firms’, *Journal of International Business Studies*, vol. 36, no. 6 (November 2005).

Griffith, David A. and Myers, Matthew B. ‘The performance implications of strategic fit of relational norm governance strategies in global supply chain relationships’, *Journal of International Business Studies*, vol. 36, no. 3 (2005).

Hagedoorn, John, Cloodt, Danielle and Kanenburg, Hans van. ‘Intellectual property rights and the governance of international R&D partnerships’, *Journal of International Business Studies*, vol. 36, no. 2 (2005).

Hannibal, Martin and Knight, Gary. ‘Additive manufacturing and the global factory: Disruptive technologies and the location of international business’, *International Business Review*, vol. 27, no. 6 (2018).

Hansen, Morten T. and Løvås, Bjorn. ‘How do multinational companies leverage technological competencies? Moving from single to interdependent explanations’, *Strategic Management Journal*, vol. 25, nos. 8/9 (2004).

Hatani, Faith. ‘The logic of spillover interception: the impact of global supply chains in China’, *Journal of World Business*, vol. 44, no. 2 (2009).

Helper, Susan and Sake, Mari. ‘Supplier relations in Japan and the United States: are they converging?’, *Sloan Management Review* (2012).

Holweg, Matthias. ‘The genealogy of lean production’, *Journal of Operations Management*, vol. 25, no. 2 (2007).

Kotabe, Masaaki and Omura, Glenn S. ‘Sourcing strategies of European and Japanese multinationals: a comparison’, *Journal of International Business Studies*, vol. 20, no. 1 (spring 1989).

Mehri, Darius. ‘The darker side of lean: an insider’s perspective on the realities of the Toyota production system’, *Academy of Management Perspectives*, vol. 20, no. 2 (2006).

Nieto, María and Rodríguez, Jesús Alici. ‘Offshoring of R&D: looking abroad to improve innovation performance’, *Journal of International Business Studies*, vol. 42 (April 2011).

Nohria, Nitin and Ghoshal, Sumantra. *The Differentiated Network: Organizing Multinational Corporations for Value Creation* (San Francisco, CA: Jossey-Bass, 1997).

Ojah, Kalu and Monplaisir, Leslie. ‘Investors’ valuation of global product design and development’, *Journal of International Business Studies*, vol. 34, no. 5 (September 2003).

Ørberg Jensen, Peter D. and Pedersen, Torben. ‘The economic geography of offshoring: the fit between activities and local context’, *Journal of Management Studies*, vol. 48, no. 2 (March 2011).

Qamar, Amir and Mark Hall. ‘Can Lean and Agile organisations within the UK automotive supply chain be distinguished based upon contextual factors?’ *Supply Chain Management: An International Journal*, vol. 23, no. 3 (2018).

Qamar, Amir, Hall, Mark A. and Collinson, Simon. ‘Lean versus agile production: flexibility trade-offs within the automotive supply chain’, *International Journal of Production Research*, vol. 56, no. 11 (2018).

Quinn, James Brian and Hilmer, Frederick G. ‘Strategic outsourcing’, *Sloan Management Review*, vol. 35, no. 4 (summer 1994).

Reddy, Prasada. ‘New trends in globalization of corporate R&D and implications for innovation capability in host countries: a survey from

India', *World Development*, vol. 25, no. 11 (November 1997).
Rondinelli, Dennis and Berry, Michael, 'Multimodal transportation, logistics, and the environment: managing interactions in a global economy', *European Management Journal*, vol. 18, no. 4 (August 2000).
Rugman, Alan M. and Bennett, Jocelyn. 'Technology transfer and world product mandating', *Columbia Journal of World Business*, vol. 17, no. 4 (winter 1982).
Rugman, Alan M. and Brain, Cecilia. 'Regional strategies of multinational pharmaceutical firms', *Management International Review*, vol. 44, special issue 3 (2004).
Rugman, Alan M., Jing, Li and Oh, Chang Hoon. 'Are supply chains global or regional?', *International Marketing Review*, vol. 26, no. 4/5 (2009).
Rugman, Alan M. and Verbeke, Alain. 'Subsidiary-specific advantages in multinational enterprises', *Strategic Management Journal*, vol. 22, no. 3 (March 2001).
Serapio, Manuel G., Jr. 'Macro-micro analyses of Japanese direct R&D investments in the US automotive and electronics industries', *Management International Review*, vol. 33, no. 3 (1993).
Shah, Rachna and Ward, Peter T. 'Lean manufacturing: context, practice bundles, and performance', *Journal of Operations Management*, vol. 21, no. 2 (2003).
Yip, George S. 'Global strategy: in a world of nations?', *Sloan Management Review*, vol. 31, no. 1 (fall 1989).

Chapter 12

MARKETING STRATEGY

Contents

Objectives of the chapter

Every multinational firm needs a marketing strategy designed to help identify sales opportunities and take advantage of them. This plan of action typically involves consideration of four primary areas: the product or service to be sold, the way in which the output will be promoted, the pricing of the good or service, and the distribution strategy to be used in getting the output to the customer. The purpose of this chapter is to examine the fundamentals of international marketing strategy. We will look at five major topics: market assessment, product strategy, promotion strategy, price strategy and place strategy. We will consider such critical marketing areas as product screening, modification of goods and services in order to adapt to local needs, modified product life cycles, advertising, personal selling, and ways in which MNEs tailor-make their distribution systems.

The specific objectives of this chapter are to:

1. *Examine* the process used to conduct an international market assessment of goods and services.
2. *Study* the criteria that affect an MNE's decision to alter a good or service in order to adapt it to local market tastes.
3. *Describe* some of the ways in which MNEs use advertising and personal selling techniques to promote their products in worldwide markets.
4. *Review* some of the major factors that influence international pricing and distribution strategies.

ACTIVE LEARNING CASE

Adidas: promoting a global sports brand

Adidas was established in 1949 by Adolf Dassler and has become one of the largest brands in the sporting industry. The clever use of a three-stripe logo design has made the Adidas brand recognisable across the world. The Adidas Group consists of approximately 180 subsidiaries, which include Reebok, TaylorMade-Adidas Golf, Rockport and CCM Hockey. The group's product portfolio is vast, ranging from footwear and clothing to accessories (bags, watches, eyewear, etc.). In 2018, Adidas employed 57,016 employees, 8 per cent of whom were located in emerging markets, 18 per cent in North America, 8 per cent in Latin America, 12 per cent in Europe, 20 per cent in Asia-Pacific, 15 per cent in Russia and 21 per cent in Group functions. The group's headquarters are located in Herzogenaurach, Germany and in 2018 the group's profit was recorded as $12.69 billion (€11.363 billion).

Global marketing strategy

Adidas's marketing beliefs revolve around the philosophy that consumers want choice; hence it incorporates the use of a multi-brand strategy which capitalises on both a mass-market approach and a niche market or segmenting approach. The firm maintains a wide range of products but with a unifying brand, so managing and enhancing this brand is its main core competence. Recognising the importance of effective international marketing, Adidas places the majority of its investments in the highest-potential markets. For instance, Adidas has been heavily investing in emerging markets, such as China and Russia, while simultaneously targeting underpenetrated markets such as the United States.

The ability to make slight modifications in the design of products has allowed Adidas to acquire a large catalogue comprising a diverse range of sporting products ranging from mass to niche. Therefore, Adidas is able to take advantage of economies of scale and price its products accordingly in order to tap into nearly every country in the world, (ideally) overcoming any cultural differences. Furthermore, Adidas has established a series of promotional partnerships with an extensive range of sports associations, namely UEFA, FIFA, NBA, NFL, NHL and the Olympic

Games. In some cases, these partnerships date back to the earliest years of the firm. So, how has Adidas used these key sporting events to engage consumers across the world and promote its own brand identity? And how effective has this strategy been? We examine the firm's involvement with the 2012 Olympic Games and the 2014 FIFA World Cup to answer these questions.

2012 Olympic Games

With over 340 independent manufacturing partners spanning Asia, America and Europe, Adidas continually develops innovative products which help athletes perform to their very best. Furthermore, Adidas has consistently built its marketing campaigns around various iconic athletes and sport personalities. Adidas's involvement with the Olympic Games can be traced back to the debut of Adidas's running shoes in Amsterdam (1928). In addition, multiple iconic achievements have involved athletes wearing Adidas's products in the Olympic Games such as:

- Jesse Owens, Berlin, 1936 (four gold medals);
- Muhammad Ali, Rome, 1960 (gold medal);
- Dick Fosbury, Mexico, 1968 (new back technique for high jump); and
- Nadia Comaneci, Montreal, 1976 (perfect 10).

Adidas anticipated that the London 2012 Olympic Games would be a key event at which it could promote its brand and expand its share of the performance sportswear and fashion sportswear market. The firm saw the UK as a style trend-setter in music and fashion for other parts of the world and this shaped the way it used the 2012 Olympic Games as a platform for targeting a more global audience. The sponsorship deal agreed by Adidas represented a new record as the broadest range of sportswear rights acquired in Olympic history. Adidas gained the right to be the 'Official Sportswear Partner of the London 2012 Olympic Games' and positioned itself as the exclusive licensee of all branded London 2012 clothing items. To guide this investment Adidas set itself four marketing objectives:

- to ensure a clear association as Sportswear Partner of London 2012, Team GB and Paralympics GB;

- to engage and excite the 14–19-year-old audience in order to drive brand preference in the UK;
- to deliver a licensed product return on investment (ROI) (branded and event branded licensee rights); and
- to become the most talked about sports brand in 2012.

One of the crucial factors for achieving its sponsorship goals was the company's direct involvement with the design and development of the athletes' kit. This provided a gateway for Adidas to connect with the target audience, while simultaneously developing new products to meet commercial sales targets. Adidas hired Stella McCartney (Paul's daughter) to create an innovative kit design and this led to the deconstructed union jack flag design.

Adidas involved the use of the likes of Jessica Ennis and Tom Daley when featuring TV adverts to increase support for Team GB. Furthermore, Adidas included TV adverts which highlighted the best UK talent across sport, including David Beckham, Wretch 32 and Derrick Rose. Adidas went on to exploit the use of social media when raising awareness of its campaign and #takethestage on Twitter became the prominent trend when supporting Team GB. In addition, Adidas used YouTube to increase awareness among customers – the reactions of individuals who were greeted with David Beckham's surprise appearance received over 3.2 million views. Adidas closely monitored every aspect of its promotional campaign, which enabled it to determine whether becoming the Official Sportswear Partner of the London Games and exclusive licensee of all branded products was financially effective. Table 12.1 illustrates how Adidas measured each of its marketing objectives. Observing this table, Adidas decided that its marketing campaign had paid off as each of its marketing objectives had been met in accordance with its measures.

2014 FIFA World Cup

Adidas not only targets the Olympic Games as an iconic event in order to promote its products, but regularly follows a similar social media strategy during prominent soccer tournaments. For the 2014 FIFA World Cup, Adidas was the official ball supplier and managed to drive up merchandise sales via the use of effective social media engagement. In order to engage with Brazilian fans prior

to the 2014 World Cup, Adidas invited fans to cast votes regarding the official name of the match ball. After receiving over 1 million votes the ball was officially named as 'Brazuca', which is an informal expression representing Brazilian Pride.

Table 12.1 Adidas's marketing objectives and measurements

	Marketing objective			
	Ensure a clear association as Sportswear Partner of London 2012, Team GB, and Paralympics GB	Engage and excite the 14–19-year-old audience in order to drive brand preference in the UK	Deliver a licensed product ROI (branded and event branded licensee rights)	Become the most talked about sports brand in 2012
Success Measures	Adidas generated the highest number of articles among local sponsors (ranked third behind McDonald's and Coca-Cola). 44 percent of 16–24-year-olds were aware of the sponsorship (Adidas's closest competitor achieved 16 percent).	YouGov (a measure of public opinion) score increased from 4.2 to 16.5 during the Games. Adidas ranked no. 1 by London 2012 Nielsen audience tracking for categories 'inspiring' and 'empowering'. Adidas' 'Don't stop me now' video was the most viewed video on www.bbc.co.uk during the Games. 8 million views of #takethestage content on YouTube, including 2.5 million views from 14–24-year-olds.	2 per cent market share growth. 100 million total licensed product sales in 2012. More sales at Adidas's Oxford Street store in London in one week than at any other Adidas store ever.	Increased Twitter followers by 25 per cent. 32 per cent share of sponsor traffic on Twitter. 128 million Twitter impressions for #takethestage.

Source: https://wethriveindia.wordpress.com/tag/adidas-marketing-strategy/.

With a marketing slogan of 'All In or Nothing', Adidas was directly competing against Nike's marketing campaign of 'Risk Everything'. Even though Nike had acquired Cristiano Ronaldo at $8.3 million as the second most expensive shoe endorser ever, Adidas's market research had identified that fans were interested more in receiving the latest information as quickly as possible rather than in the promotion of products. With this in mind, Adidas developed an innovative live hour-by-hour calendar which provided all the attention-grabbing information fans would need before a game even started. This required a heavy investment in marketing, but was deemed a success as Adidas's integrated marketing strategy generated millions of tweets while making it the most talked about brand during the 2014 World Cup. Furthermore, Adidas managed to gain the

endorsement of two key players who reached the finals: Lionel Messi and Mesut Özil, who wore the Adidas Predator Instinct Battle Pack and F50 soccer boots respectively. Furthermore, capturing a global audience, Adidas has also partnered FIFA World Cup tournaments in order to reward players for outstanding achievements throughout the competition, such as the Adidas Golden Ball, the Adidas Golden Boot and the Adidas Golden Glove.

As an MNE, Adidas's marketing mix is partly tailored for specific markets by identifying factors such as cultural and social differences. But it also benefits from the attractiveness and selling-power of global sporting superstars. Whatever their nationality or ethnicity, consumers from different nations and cultures all over the world venerate their prowess and see them as role models to emulate. The sports entertainment industry is also growing and Adidas has emphasised sports marketing within certain global regions, such as China, Russia, the UK and the United States. Adidas aims to be a market-oriented organisation which continually identifies and reviews consumer needs to guarantee that the products it releases meet customer requirements. Adidas aims not just to meet its customers' needs but to surpass their expectations by constantly adapting its products and acquiring key athletes and sporting personalities to showcase them. Even though gaining sponsorship deals with large sports events such as the Olympic Games and FIFA World Cup is extremely expensive, via the use of well-organised marketing strategies and clear objectives, Adidas has identified a clear way of engaging deeply with consumers. It is important to note that Adidas was largely supportive of Team GB before, during and after the Olympic Games, which helped it ensure the full support of the team's athletes. Effective marketing strategies, such as the London 2012 campaign and the 'All In or Nothing' campaign during the 2014 World Cup, and the company's ability to deliver innovative products both underpin the continued success of Adidas.

No matter the sporting event, Adidas will always be locked in a global battle against Nike for brand supremacy. However, Adidas's pockets are not as deep as Nike's, in fact Adidas have a marketing budget which is approximately half of Nike's. Given this, Adidas cannot afford to battle it out with Nike concerning every sporting event, which is why they are no longer focusing their efforts on securing contracts with sporting federations as a whole, but are now focused on securing contracts with the highest-profile players, clubs and national teams. For instance, in 2015, Adidas

did not renew its contract with the NBA, which was partly driven so that they could invest more in players such as James Harden of the Houston Rockets, who made a 13-year deal with Adidas reportedly worth approximately $200 million. Moreover, Adidas opted not sponsor the 2016 Rio Olympic Games and stated that, in terms of brand recognition, they had achieved most of the things they wanted to achieve in Brazil at the 2014 World Cup. Adidas stated that they would use future Olympic games as a platform to launch new products and as expected, Nike quickly secured the sponsorship at the 2016 Rio Games and took over the NBA contract from 2017.

Although Adidas were not the official sponsors for the 2016 Rio Games, one of the ways they kept consumers engaged with their brand was by mixing up social media with a Big Brother experience. Adidas got 20 key female influencers and bloggers and invited them to Rio to live together in a house. Wearing Adidas's products, these influencers visited sporting events and shared their experience, via live updates, to their followers on social media. Some of the influencers included:

- Lena Gercke (Germany, model, 911,000 fans on Facebook, 1.3 million on Instagram);
- Caro Daur (Germany, blogger, 68,000 fans on Facebook, 694,000 on Instagram);
- Faya Nilsson (UK, fitness blogger, 25,000 fans on Facebook, 105,000 on Instagram);
- Adriene Mishler (USA, fitness blogger, 210,000 fans on Facebook, 141,000 on Instagram);
- Rachel Apollonio (Brazil, model, 23,000 fans on Facebook, 1 million on Instagram);
- Kéfera Buchmann (Brazil, model, 6.9 million fans on Facebook, 8.2 million on Instagram); and
- Paulina Vega Dieppa (Columbia, model, 397,000 fans on Facebook, 2.2 million on Instagram).

(Figures correspond to 2016.)

As part of its focused strategy, Adidas is eager to defend its edge in soccer, which is the most popular sport in Europe. They struck a deal and paid a record of $1.1 billion to replace Nike as the official sponsor to Manchester United. Moreover, Adidas went on to replace Nike's sponsorship with Italian club Juventus, and extended its contract with Germany's club Bayern Munich. Reports

suggest that future Adidas deals with sporting federations will be reviewed on a case-by-case basis. However, given the wide appeal of the World Cup the German giant has no intention of leaving soccer governing body FIFA.

Websites: https://wethriveindia.wordpress.com/tag/adidas-marketing-strategy/; https://www.ispo.com/en/companies/id_78801230/influencer-marketing-from-adidas-models-at-the-olympics-in-rio-.html

Sources: Adidas, *Annual Report*, 2014, 2018; Leonid Bershidsky, 'Why Adidas beat Nike at the World Cup', *Bloomberg View*, 11 July 2014; *Times 100 Business Case Studies*, 'Planning effective marketing strategies for a target audience: an Adidas case study', businesscasestudies.co.uk; http://www.dcmarketingpro.com/what-the-2014-world-cup-taught-us-about-effective-integrated-marketing; Chris Daniels, 'Sponsors connect World Cup with US soccer growth', *PR Week*, 20 December 2013; Sebastian S. Vlasich, 'Adidas – a global sports strategy', *Business Development Strategies*, 1 January 2012; Emma Thomasson 'Digital marketing helps Adidas cut ties to sports bodies', *Reuters*, 27 January 2016.

1. **How could Adidas use international market assessment to maximise sales in different global markets?**
2. **Why does Adidas focus on promoting a single global brand and how do sports events help this strategy?**
3. **How would currency fluctuations affect Adidas's profit in the US market?**
4. **How does Adidas use online platforms and social media to promote its events, its sponsored athletes and its products?**

INTRODUCTION

International marketing is the process of identifying the goods and services that customers outside the home country want and then providing them at the right price and location.[1] In the international marketplace, this process is similar to that carried out at home, but with some important modifications that can adapt marketing efforts to the needs of the specific country or geographic locale.[2] For example, some MNEs are able to use the same strategy abroad as they have at home. This is particularly true in promotions where messages can carry a universal theme (see the **Active Learning Case: Adidas**). Many fast-food franchises apply the same ideas because they have found that people everywhere have the same basic reasons for choosing their restaurants to eat in. In most cases, however, a company must tailor-make its strategy so that it appeals directly to the local customer.

In order to customise effectively, to enter a new market MNEs must make a number of strategic decisions, as outlined in 'the internationalisation roadmap' (see Figure 2 in the opening section 'Frameworks for this Book'). These fall into five broad areas: market assessment, product and service decisions, promotion strategies, pricing decisions, and place or distribution strategies. The latter four areas – product, promotion, price and place – are often referred to as the four Ps of marketing,[3] and they constitute the heart of international marketing efforts.

INTERNATIONAL MARKET ASSESSMENT

International marketing strategy starts with **international market assessment**, an evaluation of the goods and services that the MNE can sell in the global marketplace. This assessment typically involves a series of analyses aimed at pinpointing specific offerings and geographic targets. The first step is called the initial screening.

Initial screening: basic need and potential

Initial screening is the process of determining the basic need and potential of the MNE's goods and services in foreign markets. This screening answers the question: who might be interested in buying our output? International auto manufacturers list the EU countries, North America and Japan as large markets full of potential buyers. Boeing targets the countries that will be rebuilding their air fleets in the next few decades. Kellogg's, General Mills and Nestlé are interested in the United States and the European Union as well as any developing nations that offer potential new markets. Most MNEs will want to maintain their position in mature markets and at the same time build their brand and customer awareness in growing markets.

Initial screening involves:

- examining the current import policies of other countries and identifying the goods and services being purchased from abroad;
- understanding other barriers to entry, such as tax laws, poor distribution infrastructure or cultural or religious opposition to the product or service the firm is offering;

- assessing the volume and quality of local production and local competitors;
- looking at cultural and other similarities or differences in the target markets, compared to current markets where the product or service is established; and
- researching demographic and other social, cultural, economic changes taking place in target markets that will benefit sales (or not).

These cursory efforts help an MNE to target potential markets. Following the initial screening, the company begins to narrow its selection.

Second screening: financial and economic conditions

Secondary screening is used to reduce the list of market prospects by eliminating those that fail to meet specific hurdles, including financial and economic considerations. Financial considerations include inflation rates, interest rates, expected returns on investment, the buying habits of customers and the availability of credit. These factors are important in determining whether markets that passed the initial, general screening are also financially feasible.

Economic considerations relate to a variety of market demand influences, including market indicators. **Market indicators** are used for measuring the relative market strengths of various geographic areas and focus on three important areas: market size, market intensity and market growth. **Market size** is the relative size of each market as a percentage of the total world market. For example, industrialised countries account for a sizable part of the market for cellular telephones, and a few nations such as the United States and Japan account for the largest percentage of this total. Nevertheless, emerging economies with large populations also have a significant market size. In fact, China, the world's largest country in terms of

population, is also the world's largest cell phone market in terms of subscribers. **Market intensity** indicates the degree of purchasing power in one country compared to others. For example, the United States and Canada are extremely rich markets for automobiles, telephones and computers, so MNEs selling these products tend to highlight these two countries. **Market growth** is the annual increase in sales. For example, the market for cell phones, laptop computers and autos in the United States is likely to continue to grow more slowly in the years ahead, compared to China. However, given the large purchasing power in the US economy, MNEs selling these products will continue to target the United States. In recent years, other economies, such as South Korea, have become increasingly rich in terms of purchasing power, so they too are now target markets for high-tech products. Infrastructure and economic development can also influence market growth. For example, consumers in developing countries who have not yet been able to acquire a fixed line might choose instead to purchase a portable phone. This is described as 'leap-frogging' in some cases, where entire technology platforms are missed out of the development trajectory of a country.

Quite often these data are analysed through the use of quantitative techniques. Sometimes these approaches are fairly simple. **Trend analysis**, for example, is the estimation of future demand either by extrapolating the growth over the last three to five years and assuming that this trend will continue, or by using some form of average growth rate over the recent past. A similar approach is **estimation by analogy**, through which forecasters predict market demand or growth based on information generated in other countries. For example, if the number of refrigerators sold in the United States is 2.5 times the number of new housing starts, a US MNE that is planning to manufacture these products in the European Union will estimate demand based on the same formula. A more sophisticated approach is the use of **regression analysis**, a mathematical approach to forecasting that

attempts to test the explanatory power of a set of independent variables. In the case of selling refrigerators in the European Union, for example, these variables would include economic growth, per capita income and the number of births, in addition to other variables such as new housing starts. Another sophisticated approach is **cluster analysis**, a marketing approach that involves grouping data on the basis of market area, customer and so on, based on similar variables, so that a marketing strategy can be formulated for each group. For example, US MNEs providing services in such areas as insurance, legal, financial and management consulting know that their approaches must often vary from country to country.

Third screening: political and legal forces

The third level of screening involves taking a look at political and legal forces. A primary consideration is entry barriers in the form of import restrictions or limits on local ownership of business operations. Analysis of these barriers often results in identifying loopholes around the various restrictions or data that indicate barriers are far less extensive than initially believed. For example, some MNEs have been able to sidestep legal restrictions by forming joint ventures with local firms. Production restrictions or limitations on profit remittance that restrict operating flexibility must also be considered. Government stability is an important factor in starting a successful operation; however, it is often difficult to predict. Another consideration is the protection offered for patents, trademarks and copyrights. In some countries, such as China and Taiwan, pirating has been fairly common, resulting in markets being flooded with counterfeit or look-alike products. (Country risk analysis is dealt with more extensively in Chapter 14.)

Fourth screening: socio-cultural forces

The fourth level of screening typically involves the consideration of socio-cultural forces such as language, work habits, customs, religion and values. As noted earlier, culture greatly affects the way people live, and MNEs need to examine how well their operations will fit into each particular culture. For example, although Japanese auto manufacturers have set up assembly plants in the United States, those operations are not identical to the ones in Japan because of the work habits and customs of Americans. In the United States, the work pace is less frantic and most people are unwilling to work the typical 5½-day week which is so common in Japan. Moreover, US managers are accustomed to going home to their families after work, whereas Japanese managers often go out for dinner and drinks and discuss business until late in the evening. MNEs will examine these socio-cultural differences in determining where to locate operations.

Fifth screening: competitive environment

The fifth level of screening is typically focused on competitive forces. If three or four locations are equally attractive, an MNE will often make a final choice based on the degree of competition that exists in each locale. In some cases, companies do not want to enter markets where there is strong competition. However, they will often decide to enter a competitive market because they believe the potential benefits far outweigh the drawbacks. By going head-to-head with the competition, the company can force itself to become more efficient and effective, and thus improve its own competitiveness. The MNE can take market share away from competitors and put them on the defensive, forcing them to commit more resources to defending the market under attack and thereby reducing their ability to retaliate effectively. Of course, these conditions do not always hold true, but they help illustrate why MNEs consider entering markets that are dominated by competitors.

Final selection

Based on the outcome of the screenings and the supplemental data, the MNE chooses which goods and services to offer to which markets overseas. The marketing strategy employed in this process revolves around what are commonly called the four Ps of marketing: product, promotion, price, and place. Site visits or participation in trade missions can also help manager gain a deeper understanding of the opportunities and risks of entering new markets.

Active learning check

Review your answer to Active Learning Case question 1 and make any changes you like. Then compare your answer to the one below.

1 How could Adidas use international market assessment to maximise sales in different global markets?

Adidas could use a number of market assessment tools to help it target particular markets to enter and sell its products, or expand its current sales. Because it sells relatively high-end consumer goods, a screening of financial and economic conditions would provide data on disposable income, local consumer preferences, and trends in buying patterns to estimate current and future demand for its products. This should be done alongside analyses of social and cultural forces which will affect consumer preferences and the likely effectiveness of the firm's marketing strategy. Global sports celebrities are more attractive as fashion icons in some parts of world than others. Variations in religion, ethnicity and cultural norms are important factors when planning a global marketing campaign. Political and legal factors are usually linked to the socio-cultural context and will affect how easily the firm can enter the market and do business locally. These also influence the local media, which Adidas is heavily reliant on for its marketing approach. Finally, it should assess the degree to which competitor brands are targeting a particular country market. This may indicate that it is attractive and worth focusing on, but competition will add costs and put pressure on the firm to customise its product offering in a particular market.

PRODUCT STRATEGIES

Product strategies vary depending on the specifics of the product itself and the characteristics of the target market segment. Some products can be manufactured and sold successfully both in the home country and abroad by using the same strategies. Other products must be modified or adapted and sold according to a specially designed strategy. Figure 12.1 shows a range of possibilities. Products and services located on the left side of the continuum require little modification; those on the right must be modified to fit the market. To some degree this range of options parallels the more general international business manager's challenge to strike an appropriate balance between being 'global or local', to standardise or customise, to integrate across all dimensions of the business or respond to local differences. This is discussed in Chapter 10 in relation to the integration-responsiveness framework.

Little or no modification

Industrial goods and technical services are good examples of products that need little or no modification. A bulldozer, a laptop and a photocopying machine serve the same purposes and are used the same way in the home country as they are abroad. Alterations would be minor and would include such things as adapting the machine to the appropriate electric voltage or changing the language used for its instructions and labels. The same is true for many types of services. For example, international engineering and construction firms find that their product strategies are similar worldwide. People interested in having a dam or power plant constructed use the same basic concepts and have similar needs throughout the world. In fact,

experience is the greatest selling point in convincing clients to hire an MNE in engineering or construction. Foreign design and construction firms that proved themselves in the Burj Al Arab Hotel project in Dubai, for example, were invited to participate in the unprecedented Palm Jumeirah artificial island project.

Figure 12.1 Selected examples of product modification in the international arena

Companies with a strong international brand image have also been able to succeed without a differentiation strategy. For example, the world-famous Scotch Chivas Regal is sold in many countries and is identical in each one. Schweppes (tonic water) and Perrier are internationally known and are also identical worldwide.

Moderate to high modification

A number of factors can compel an MNE to use moderate to high product modification. These include economics, culture, local laws and product life cycle.

Economics

There are many examples of how economic considerations affect the decision to modify a product. For example, chewing gum packages often contain 10 to 20 sticks in the United States. But in many other countries, weak customer purchasing power necessitates packaging the gum with only five sticks. Countries vary in terms of the use of cars versus public transport and in terms of average house sizes (therefore storage space), so buying patterns also vary accordingly and firms must customise product size and packaging to suit local preferences.

Economics is also important when the cost of a product is either too high or too low to make it attractive in another country. Locally appropriate, stripped-down versions without added extras will sell better at lower costs if targeting lower-middle-class consumers in emerging markets. Similarly, in economically advanced countries products are likely to have frills or extras, whereas only the basic model is offered in poorer countries. For example, bicycles in advanced economies come in many shapes and sizes, specialised for different uses. In other countries they are more basic, as a primary source of transportation, built for economy and ease of maintenance. As a result, manufacturers need to modify the product to fit customer needs.

Culture

A product must sometimes be adapted to different ways of doing things. Consider washing machines. The French prefer washers that load from the top, the British like front-loading units, the Germans prefer high-speed machines that take out most of the moisture in the spin-dry process and the Italians like slower spin speeds because they prefer to hang-dry laundry in the sun. So manufacturers which sell washing machines in the European Union must produce a variety of different units.

Food is an item that often must be modified or sold differently. In fast-food franchises like McDonald's, portions of the menu are similar

throughout the world while other items are designed to cater specifically to local tastes. Coffee in South American units tends to be a much stronger blend than that sold in North America. In certain parts of Europe and Asia, the food is more highly seasoned in keeping with local tastes. For products that are not modified, the marketing focus is different because of the way the item is used. Schweppes, for example, is typically served as a mixer in the United States and UK, where drinks like gin and tonic are popular. In France, however, it is drunk without alcohol. Clearly, marketing approaches differ in these two situations. The marketing message is also important when selling hard liquors. The products remain the same, but many places have social customs that frown on excessive consumption. In these cases, MNEs such as Seagram of Canada have tailored their advertising messages along the lines of moderate drinking and the use of mixers to reduce the alcoholic content per serving.

Culture also influences purchasing decisions on the basis of style or aesthetics. Cosmetics and other beauty aids are good examples. Perfumes that sell well in Europe often have difficulty gaining market share in the United States because they do not appeal to American women. Similarly, many products that sell well in the United States, such as shampoos and deodorants, have limited market appeal elsewhere. People may not use these products, or they may find it hard to differentiate a product from local offerings.

Other culturally based reasons for product modifications include colour and language. In the United States, the colour black is worn for mourning, whereas in other countries white is for mourning and thus is not used for consumer goods. Similarly, most European shampoos are light coloured, whereas in some Oriental countries consumers prefer dark-coloured shampoo. Language can be an important point of modification because a product may need to carry instructions about contents or use. Language is

also important in conveying the right image for the product. Quite often it is difficult to replicate the message because the saying or slogan has no meaning in another language.

Local laws

Local laws can require product modification in order to meet environmental and safety requirements. Auto emission-control laws, food and pharmaceutical regulations are examples where require products, packaging and labelling need to be configured to meet varying regulations around different country markets. In Saudi Arabia, the label of any product containing animal fat or meat must clearly state the kind of animal used and the fact that no swine products are included. Brand name protection can also require product modification. Ford found that in Mexico it had to rename its Ford Falcon because this brand name was registered to another firm. The same thing happened to Ford in the case of the Mustang in Germany.

Product life cycle

Another reason for modifying a product is to cope with its limited product life cycle (PLC). Although Ford was extremely profitable in at one point in Europe it has also struggled because it did not develop new, competitive products. Contrast this to Coca-Cola of Japan, which introduces an average of one new soft drink per month and has the competition scurrying to keep up. Yet Kola Real has been particularly effective in offsetting the technology and marketing of Coca-Cola to bring its own products to market in Mexico.

One of the most effective strategies has been to shorten the PLC by offering new goods and services before the demand for the old ones has dropped significantly. Figure 12.2 provides a graphic illustration. Note that there are two types of PLCs: (1) the standard PLC, which covers an extended time continuum, often four to five years; and (2) a short life cycle that lasts a

much shorter time. Many companies are discovering that by shortening the PLC and offering new product adaptations they are able to capture and retain a large market share. This is typically done by offering a new product, then modifying it, and bringing out a new version before the competition can effectively combat the first offering.

INTERNATIONAL BUSINESS STRATEGY IN ACTION

Weeby buys Tappy

The first Vietnamese technology company to be acquired by a Silicon Valley company was Tappy, bought by Weeby to gain access to the Asian mobile gaming market. Tappy was founded in January 2014 by Thuy Truong, a 'serial entrepreneur' educated at the University of Southern California and now based in her native country, Vietnam, and Singapore. Her first start-up was 'Parallel Frozen Yogurt', a frozen yogurt chain launched in 2008. She then co-founded GreenGar, in October 2010, which produced apps for iOS, Mac and Android platforms. Among the popular of these was the 'Whiteboard: Collaborative Drawing and Brain Tuner' app GreenGar, which achieved 13 million downloads in less than three years.

Tappy is a location-based social messaging application which enables people at a bar or an event to connect to each other. Weeby.co, based in Mountain View, California, is a cloud-based game-building platform which bought Tappy for an undisclosed seven-figure sum. Having raised $12 million in venture capital, Weeby.co has invested in messaging, gaming social networks and game production, through its main product Weeby.co Producer. This allows anyone to create a game and launch it on Weeby.co's platform. Weeby.co's CEO, Michael Carter said:

> The team at Tappy are veteran operators in the Southeast Asia region. By acquiring Tappy and bringing on board the management team, we're jumping forward half a decade in business and strategic partnerships. The region is one of the fastest growing on the planet.

The investment is part of an upsurge in interest from foreign firms in the Vietnamese tech sector. First, it is a large and growing market, with an expanding middle class who tend to use their mobiles, rather than laptops or games consoles, to both play and communicate. It is also a potential entry point to other markets in Southeast Asia. Second, it is home to a rising number of high-tech start-ups in social media sector. Misfit Wearables, a small but very global high-tech firm based in San Francisco, Seoul and Ho Chi Minh City, recently received a significant investment from Chinese smartphone manufacturer Xiaomi.

Foreign firms are entering into alliances or joint ventures with, or acquiring, local firms partly to tap into local skills and expertise to produce better products. They are following larger MNEs which have already invested in consumer electronics, computing and communications sectors to take advantage of the country's cheap but well-educated labour force. Samsung is the largest foreign investor with approximately $17.3 billion of FDI underpinning $54 billion in export turnover in 2017 (approximately 25 per cent of Vietnam's total exports). Samsung's investment in Vietnam has been in eight factories and one research and development centre, which has transformed the nation into its largest smartphone production base. But foreign firms are also using these 'modes of entry' (alliance, joint venture or M&A) to access a growing market of young tech-savvy consumers who appear to be ahead of the curve in mob services. The Vietnamese are buying, adopting and co-developing online services in ways that are likely to be followed by Western consumers in the future.

The Vietnamese government is trying to make it easier for firms to set up in the country, partly by easing restrictions on foreign ownership. It is also investing in new business growth, with an emphasis on technology-based start-ups. Vietnam's Minister of Science and Technology, Nguyen Quan, said he believed start-ups should grow from universities or research institutes. 'The country can now start with a start-up university, then a start-up city, to gradually become a start-up nation', he emphasised. Quan revealed the goal of having 5,000 tech companies by 2020. As of 2018, with around 3,000 start-ups, Vietnam is the third largest start-up ecosystem in the whole of Asia. As of 2017, within the 127 economies listed on the Global Innovation Index, Vietnam has jumped a staggering 12 places to 47th. Only Singapore and Malaysia are ranked higher on the Global Innovation Index in the region. This puts Vietnam as one of the fastest-growing economies in the world and if this trend continues, the nation is on track to become the twentieth largest economy in the world by 2050.

If this is to happen, global entrepreneurs like Thuy Truong are an essential ingredient. They have the skills and the drive to build innovative new small firms. But they also bring an international network, from their personal experience living and working in different places, integrating skills and expertise (with different costs) from different locations to add value for consumers wherever they are located. Policy-makers like Nguyen Quan would do well to

understand what attracts young entrepreneurs to return to their homeland. By developing the attractiveness of the home-country environment, Vietnam could encourage a growing number of entrepreneurs to invest their creative energies back in their home country.

Websites: https://thenextweb.com/contributors/2018/11/15/an-entrepreneurs-guide-to-vietnams-startup-scene/; https://www.portcalls.com/vietnams-2017-exports-reach-214b-21/#; https://www.reuters.com/article/us-samsung-elec-vietnam/samsung-electronics-to-expand-production-in-vietnam-idUSKBN1HR1SD

Sources: Edward Barbour-Lacey, 'Samsung increases investment into Vietnam's Saigon hi-tech park', *Vietnam Briefing*, 8 October 2014; Anh-Minh Do and Steven Millward, 'Silicon Valley's Weeby.co leaps into Asia by acquiring Vietnam's Tappy', 26 May 2015; Duncan Riley, 'Cloud games platform provider Weeby.co acquires Vietnamese social app Tappy', *Silicon Angle*, 26 May 2015; https://www.crunchbase.com; 'Vietnam startup scene poised to takeoff as ecosystem comes together', *Deal Street Asia*, 18 May 2015; James Hookway, 'Tech firms flock to Vietnam: global names accelerate one of the developing world's fastest transformations ever, *Wall Street Journal*, 27 September 2013; Conrad Egusa 'An entrepreneur's guide to Vietnam's startup scene', The Next Web, 2018.

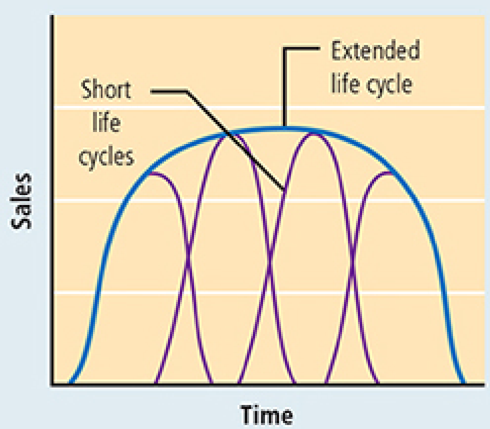

Figure 12.2 Product life cycles: two different approaches

As long as a firm can continue an adaptation strategy, it can outmode the old product (and those of competitors as well) and maintain market position. At some point the competition may gain the advantage by offering a product or service that revolutionises the field, but as long as a product improvement strategy remains viable, the firm will continue to be the market leader. Different kinds of 'dynamic capabilities' are required to succeed for fast, incremental innovation to adapt existing products and services, as opposed to radical or disruptive innovation which drives completely new kinds of products and services. For MNEs, with business functions based in different countries around the world, incremental innovation requires a strong connection between subsidiaries located next to the main consumer markets, with knowledge of their needs,and the product development teams. Radical, R&D-driven innovation can often succeed better when teams are disconnected from consumers, but is more risky.

PROMOTION

Promotion is the process of stimulating demand for a company's goods and services.[4] MNEs promote their goods and services through advertising and personal selling. The specific approach used, however, will be determined by the nature of the product.

Nature of the product

In promoting a product, a company can use a variety of approaches. The choice is heavily influenced by whether the firm believes the same message can be used worldwide or needs to be adapted, and whether the product will remain the same or need to be modified. Here are four variations on this theme:

- *Identical product and identical message.* This approach is used when the MNE intends to sell the same product worldwide and believes that an identical promotional appeal can be used in all markets. A. T. Cross, for example, uses this strategy because writing instruments do not need to be adapted to local markets.
- *Identical product but different message.* This strategy is used when the product satisfies a different need in various markets. For example, in the United States many car companies tout the luxury and convenience of their products, whereas in other countries the same cars are promoted on the basis of their fuel efficiency or ability to meet basic transportation needs.
- *Modified product but same message.* This strategy is used when the market requires a different version of the product but the needs of the

consumer are the same. For example, whether washing machines load from the top or the front, they provide the same function and meet the same customer needs. Similarly, the seasoning of foods differs in countries around the world. So although the product is changed, the promotion message remains the same because the buyer's needs are the same.

- *Modified product and modified message.* When the product use and buying habits of customers are different from those in the MNE's home market, both the product and promotion message will be modified.

Advertising

Advertising is a non-personal form of promotion in which a firm attempts to persuade consumers to a particular point of view. In many cases MNEs use the same advertising message worldwide; again, because many products fulfil similar worldwide needs, a company can use a universal message and reduce advertising costs at the same time. However, there are times when the advertising must be adapted to the local market. Two of the most common reasons are that (1) the way in which the product is used differs from that in the home country, and (2) the advertising message does not make sense if translated directly. As a result, advertisers are very careful to tie their messages to buyer needs and wants. On the other hand, there are many advertisements that have been only moderately modified or carried in their entirety because they do make sense in other cultures. For example, Nike's ads featuring such internationally known sports stars as Tiger Woods and David Beckham transcend national boundaries, especially after the media exposure they have received.

INTERNATIONAL BUSINESS STRATEGY IN ACTION

The 2018 retail crisis catches up with Marks & Spencer

Since its inception as a small market stall in Leeds (UK) in 1884, M&S has grown to become an iconic British clothing retail firm that employs approximately 85,000 employees across 1,433 stores worldwide. However, in 2018 M&S announced the closure of 14 stores, followed by plans to close a total of 100 stores in the UK by 2022. Reportedly, the closure of these 14 M&S stores jeopardises 600 jobs. With an average of 43 employees per store, the closure of 100 stores will put 4,300 jobs at risk. These job losses are part of a wider 'radical transformation' initiative at M&S, which has already seen the firm close 22 clothing stores and axe 900 jobs, but also involved the refurbishment of other stores, with associated costs approximately $417 million. This investment, in light of the challenges facing the UK high street, was perhaps a little risky. Either way, M&S have gone through a process of shrinking their operations to try and ensure future viability.

Continued dependency on the UK domestic market

In 2014, M&S announced a target to open 250 new stores overseas by 2017. This expansion would focus on China, Russia, India, the Middle East and Western Europe and this push was driven because M&S wanted to increase international sales by approximately a quarter. However, in 2015 the results from the first phase of international expansion were underwhelming. More specifically, international operating profit dropped 25 per cent to around $141 million. M&S stated that the two key countries they had targeted had changed politically and economically. Had Russia not decided to invade Ukraine and if China's economy had continued its historical growth rate of 9 per cent, the M&S leadership felt that their international growth levels would have been very different. But, with these setbacks, M&S quickly slowed its overseas expansion.

By 2019, M&S had a presence in 57 countries across the world, primarily in food and clothing and home products. Although they had diversified their offerings to include services in banking and energy, this was a small part of the business. M&S grew from having a presence in just a handful of countries after the Second World War to over 400 stores in Europe, the Middle East and

Asia. Moreover, the firm had an online presence in North America, Australia and New Zealand. The majority of international stores were run on a franchise basis, with relatively few operating as fully M&S-owned stores, and in Czech, Greece and India M&S stores were run as joint ventures.

However, M&S's broad international presence does not reflect its true position. Although it is a global firm that serves 32 million customers every year, the majority of its sales are in the UK. The firm generated an impressive revenue of approximately $13,809 million in 2017. However, approximately 89 per cent of this came from the British market, making the firm highly dependent on the UK market. Although M&S has been a bastion of the British high street, the scope of their operations does expose the firm to risk; if the UK retail industry suffers, this will have a severe impact on the organisation.

But the firm has already been suffering declining pre-tax profits, from $889 million in 2016 to $798 million in 2017 and $745 million in 2018, indicating structural and strategic problems. Moreover, this decline is not a recent phenomenon; M&S has been slowly deteriorating over the last two decades. In 1997, M&S achieved its peak clothing market share of 13.5 per cent in the UK, but 20 years later the firm could only lay claim to 7.6 per cent of the market, coming in marginally ahead of Primark's market share of 7 per cent. It is therefore important to try and understand what went wrong to explain this erosion in their market position.

Brand

The M&S brand is certainly well known, yet much of the organisation's past and present issues are attributable to the brand itself. More specifically, M&S has been struggling with 'strategic drift'; a gradual deterioration of competitiveness due to a failure to sense and respond to threats and opportunities in its business environment. For instance, M&S has undoubtedly acquired loyal customers over the years, but these loyal customers are typically 'older' in comparison with customers who shop in H&M, Zara etc. Shopping habits also show that the problem with acquiring loyal customers who are older is that they are less likely to purchase new outfits on a regular basis. Importantly, M&S didn't gain an 'older' customer demographic from day one; customers have perhaps grown up with the brand. M&S is not as successful at attracting new, young customers compared to high-street rivals. The firm has failed to keep pace with changing fashion trends in

order to attract the younger demographic, resulting in the current perception of M&S's brand suiting the fashion tastes of the 'older' generation.

Rather than being perceived as a key player in the fast fashion market, M&S has cultivated a reputation based on classic styles and quality clothing; but this reputation is also at risk. By going head to head with lower-cost providers, the firm compromised on quality, leaving consumers unclear as to its value proposition in a crowded market. This has had a negative impact on their brand and identity. A strategy to create sub-brands, which included Per Una and Limited Edition, also appeared to 'dilute' its brand and confuse consumers in target markets. While trying to appeal to both loyal, core customers, as well as attract new, younger shoppers, M&S is got 'stuck in the middle'.

Shift to online shopping

As with all retailers, M&S is currently facing more competition than ever as the internet has made it extremely easy for customers to compare prices and shop around. In fact, GlobalData has reported that approximately 25 per cent of all footwear and fashion related products in the UK are now purchased online. The opportunities provided by the internet have resulted in brands such as ASOS growing their dominance in the retail market which is leading to the demise of traditional shopping. This has resulted in high street retailers experiencing lower footfall, and in turn, a decline in in-store sales. This affects the profit margins that respective stores can achieve, and in turn firms such as M&S must make difficult decisions about the future viability of particular outlets.

Too many stores

The decision by M&S to close 100 stores in the UK will reduce their total number of stores by 30 per cent. It has been reported that even these significant closures will not be enough and that M&S should further downsize to ensure longer-term survival. The need to reduce high street presence is not the only issue; many of M&S's stores have not been refurbished for a number of years or even decades, which has left them looking quite old, scruffy and inevitably less attractive for customers to enter. Despite the introduction of coffee shops and other services in a bid to be inviting to

customers, more work is required to encourage footfall. However, refurbishment costs money, a luxury which M&S doesn't have. It may seem that M&S is able to offer respite from the tough conditions facing the clothing retail industry, but unfortunately, this segment of the business is also experiencing negative growth. This is because rivals such as Waitrose and even Aldi have caught up with the market and started to provide food products similar to M&S, eroding its competitive advantage.

Conclusion

In summary, M&S have failed to adapt their products in line with fashion trends, resulting in older customer demographics. Acknowledging this, M&S have attempted to acquire a 'younger' demographic via sub-brands, but this has ultimately resulted in confusion with regard to the target market, as well as quality issues. These factors have left M&S without a clear identity and have damaged the M&S brand. The shift to online shopping, combined with the uninviting appearance of the firm's dated clothing stores, have resulted in M&S experiencing difficulty in maintaining the performance of their high-street stores.

All of this underlies the decision to close 100 stores by 2022. M&S is not the only firm to be facing challenges in this tough market environment. The needs of customers are changing and M&S, as well as many other retailers, are unable to adapt quickly enough to maintain profitability, particularly as the internet has given rise to new business models which allow for greater profitability due to reduced fixed costs. Recent years have seen the demise of BHS, a once stoic rival to M&S, and the retail crisis that has unfolded in 2018 has already claimed Toys R Us, Maplin and New Look as victims, and unfortunately, M&S may well join this list.

Sources: http://www.bbc.co.uk/news/business-43240996; http://www.bbc.co.uk/news/business-43871596; http://www.bbc.co.uk/news/business-44197128; M&S Annual Report 2017; https://www.theguardian.com/business/2018/may/23/seven-reasons-why-marks-spencer-is-in-trouble; https://corporate.marksandspencer.com/aboutus/mands-international; https://uk.reuters.com/article/uk-marks-spencer-international-idUKKCN0R813H20150908.

MNEs use various media to market and promote products and services, but there are restrictions in different countries on what can be presented. Examples include: (1) some countries prohibit **comparative advertising**, in which firms compare their products with those of the competition; (2) some countries do not allow certain products to be advertised because they want to discourage their use (such as alcoholic beverages and cigarettes) or because they want to protect national industries from MNE competition; and (3) most countries censor the use of messages for religious or ethical reasons, but the degree to which – and ways in which – this is regulated varies a great deal across the world.

Active learning check

Review your answer to Active Learning Case question 2 and make any changes you like. Then compare your answer to the one below.

2 Why does Adidas focus on promoting a single global brand and how do sports events help this strategy?

A simple answer to the first part of this question is: 'because it can.' Although it has a broad portfolio of products in terms of styles and types of sports equipment – particularly shoes – Adidas sells the kind of product that needs little or no modification or customisation for local markets. Geographic segmentation is much less important than segmentation by income (luxury/premium to mass-market) and age group. Sports events help promote a standard brand because sport is a global phenomenon. There is arguably more of a shared interest in key sports (athletics, swimming, soccer, etc.) across different cultures than in music, art or cinema. This enables Adidas to reap huge economies of scale not just in manufacturing but more importantly in marketing and brand promotion.

Personal selling

Personal selling is a direct form of promotion used to persuade customers to a particular point of view. Some goods, such as industrial products or those that require explanation or description, rely heavily on personal selling. Avon, the cosmetics company, has been very successful with this approach even in countries where people are unaccustomed to buying cosmetics from a door-to-door salesperson. In Mexico, for example, Avon managed to gain acceptance by first introducing the idea of personal selling through a massive advertising campaign, so that housewives became aware that the Avon salesperson was not a common door-to-door vendor but a professional

trained to help clients look beautiful. Personal selling is also widely used in marketing products such as pharmaceuticals and sophisticated electronic equipment. For example, Pfizer and Upjohn use salespeople to call on doctors and other individuals who are in a position to recommend their products, and General Electric salespeople use the same approach in selling overseas that they use in the United States.

Because many international markets are so large, some MNEs have also turned to telemarketing. This approach has been very successful in the United States, and the overseas subsidiaries of such US firms as IBM and Ford have been using telemarketing to generate new sales. European firms such as Peugeot have been adopting this approach as well.

MNEs have also focused attention on recruiting salespeople on an international basis. In some countries this work is not highly regarded, so MNEs have given these people managerial titles that command importance, such as territory manager or zone manager. Recruiting local talent is extremely important because these people are often better able to sell to local customers. If the product requires special training to sell, MNEs often bring new salespeople to the home office for training, introduce them to those who are manufacturing the products and create a feeling of teamwork among the field staff and personnel so that the salespeople are energised to go back into the field and sell.

Online selling has grown dramatically in the last decade. The role of **social media 'influencers'** as promoters of products or services has also grown rapidly. They may have unique knowledge or expertise, but are often celebrity brands, with large online groups of followers because of their style, humour or eccentricity. Instagram, Facebook, twitter, snapchat and other platforms are used by the Kardashians, Huda Kattan or Zach King who are paid large sums to support particular brands. Global media, sports, music and fashion all underpin economies of scale for these personalities and the

brands they support. MNEs have the scale to buy into these as online promoters for their global products.

PRICING

The pricing of goods and services in the international marketplace is often influenced by factors present in home-market pricing. These factors include government controls, market diversity, currency fluctuations and price escalation forces.

Government controls

Every nation has government regulations that influence pricing practices. Some countries dictate minimum and maximum prices that can be charged to customers. Minimum prices can help protect local companies from more efficient international competitors because of a floor on price that can help ensure a profit for national firms. For example, if the minimum price for a particular type of personal computer is $1,000 and local companies can produce and sell the product for $700, they will make $300 a unit. Foreign competitors may be able to produce and sell the product for $500 and make a $500 profit per unit, but the minimum price laws prevent them from driving out local competition. Without this law, overseas competitors might price the unit at $600 and then raise the price dramatically after local competitors went out of business.

Governments also prohibit dumping, or the selling of imported goods at a price below cost or below the cost in the home country. The General Agreement on Tariffs and Trade (GATT) and WTO specifically prohibit this practice, which is designed to help MNEs drive out the local competition, establish a monopoly, and subsequently raise prices at will. A number of US firms have been influential in getting the US government to bring dumping charges against Chinese competitors.

Market diversity

Consumer tastes and demands vary widely in the international marketplace, resulting in MNEs having to price some of their products differently. For example, companies have found that they can charge more for goods sold overseas because of the demand. In the United States, there is a greater demand for light turkey meat than for dark turkey meat. The latter is typically sold at a lower price and is often purchased by animal food producers. However, the plump dark meat of turkey thighs has a strong market in Europe.

A second factor influencing market diversity is the perceived quality of the product. For example, in the United States, German auto makers such as Mercedes found that some Americans were willing to pay a premium for German cars. In contrast, the Japanese are not willing to pay a premium for German autos, so Mercedes' pricing structure in Japan is different.

Another factor is the tax laws and attitudes about carrying debt. In the United States, some interest payments are tax deductible and most people have no aversion to assuming at least some debt. In many other countries, interest payments are not tax deductible and people are unaccustomed to carrying debt. In Japan, for example, little use is made of consumer credit. In pricing products, MNEs will adjust the local strategy to accommodate the impact of the tax laws and the consumer's willingness to assume debt.

Currency fluctuations

When selling products overseas, MNEs often end up assuming the risks associated with currency fluctuations (see Chapter 7). This risk is particularly important when the companies have a return on investment target because this objective can become unattainable if the local currency is devalued. For example, if it costs BMW $40,000 to manufacture and ship a

particular model to the United States, and the company sells the car to its dealer for $50,000, BMW is making a 25 per cent profit on the sale ($10,000/$40,000). However, if the dollar decreases in value by 10 per cent against the euro, then the company's profit percentage will decline and the firm will have to choose between the following options: (1) increase the price of the car to the dealer to make up the loss of dollar value; (2) absorb the loss and leave the price the same; or (3) absorb part of the loss and raise the price to the dealer to make up the difference.

Price escalation forces

A problem similar to that discussed above is price escalation forces that drive up the cost of imported goods. In the case of BMW, for example, if the cost of the car rose from $30,000 to $33,000, the company would want to pass this along to the dealer. In the case of MNEs that sell through a marketing channel with a series of intermediaries, the effect of a price escalation can be even greater because everyone in the channel adds a percentage increase. For example, if an MNE exports and sells a consumer good for $10 to a large wholesaler and there are five additional intermediaries in the channel, each of whom marks up the good by 20 per cent, as seen in Table 12.2, the final price to the consumer is $24.88. If the MNE's cost rises from $10 to $13, the final price to the consumer is now $32.35, a 30 per cent increase. So price increases by the MNE can dramatically affect what the customer pays, and as long as the company continues to export rather than manufacture locally, price will be a key marketing consideration because of its effect on consumer demand. In this example it is likely that customer demand would drop substantially unless there were no effective substitutes for the product.

Table 12.2 The effect of MNE pricing on final consumer costs

MNE price	Price charged by each intermediary				
	1	2	3	4	5
$10	$12.00	$14.40	$17.28	$20.74	$24.88
$13	$15.60	$18.72	$22.46	$26.96	$32.35

Ultimate effect of a $3 increase in MNE price: $32.35 — $24.88 = $7.47 or 30 percent.

Active learning check

Review your answer to Active Learning Case question 3 and make any changes you like. Then compare your answer to the one below.

3 How would currency fluctuations affect Adidas's profit in the US market?

To answer this question we need to understand where the firm's products are manufactured. According to its website, 64 per cent of its supply comes from Asian countries, including China, Vietnam and Indonesia. We can then examine fluctuations in the US$ against a basket of these Asian currencies. So if the US$ fell in value by 10 per cent against these other currencies, Adidas would earn 10 per cent less from each sale *relative* to the costs of manufacture. Effectively its income in US$ is worth less in terms of the currencies which it uses to pay its suppliers. A more complex and real-world answer, however, would take into account other costs incurred by the firm. These include marketing, distribution and sales in the United States (in US$) and across its European operations (in euros and possibly £s).

PLACE

The importance of international logistics was discussed in Chapter 11. The focus of attention here will be on the distribution differences among countries and conditions with which MNEs must be familiar. **Distribution** is the course that goods take between production and the final consumer. This course often differs on a country-by-country basis, and MNEs will spend a considerable amount of time in examining the different systems in place, the criteria to use in choosing distributors and channels, and how to employ distribution segmentation.

Different distribution systems

It is often difficult to standardise a distribution system and use the same approach in every country because there are many individual differences to be considered. For example, countries such as Finland feature a predominance of general line retailers that carry a wide assortment of merchandise. In contrast, the wholesale and retail structure in Italy is characterised by a wide array of stores, many of which specialise or carry limited lines of merchandise. So in distributing goods in these two countries, MNEs need to employ different strategies.

Consumer spending habits can also negate attempts to standardise distribution. In the United States, many intermediaries are geared to handling credit sales, whereas in Japan most consumer purchases are on a cash basis. In both Germany and the United States, mail-order buying has increased dramatically in recent years, whereas in Portugal and Spain the market is quite small. So the route that the goods take to the consumer will vary.

The location where consumers are used to buying will also influence distribution. In economically developed countries where supermarkets have become commonplace, customers purchase a wide variety of food and other products under one roof. In most countries, however, purchases are made in smaller stores, and distribution requires the MNE or the local sales manager to deal with a large number of retailers, each of which is selling a small amount of merchandise. Some wholesalers and retailers have been expanding their operations to other countries for many years. Walmart, the giant US retailer, expanded into Mexico and Europe and bought the British supermarket chain ASDA back in 1999. However, most intermediaries operate exclusively within one country – another factor helping to explain why it is still difficult to standardise distribution on an international basis.

Choosing the best distribution system

MNEs use a number of criteria in creating the most efficient distribution system. One is to get the best possible distributors to carry their products. A key factor in evaluating potential distributors is the financial strength of the wholesaler or retailer, because the multinational wants to know that the distributor will be able to survive in the long run. MNEs that sell goods requiring periodic maintenance and servicing will be interested in businesses that can keep sufficient inventory on hand. This is particularly important when selling products such as autos, computers and electronic equipment. A second factor is how well connected the distributor is in terms of knowing the right people and providing assistance in handling governmental red tape. This is a key consideration for Coca-Cola when choosing overseas distributors. A third factor is the number and types of product lines the distributor carries currently, so that the multinational can identify intermediaries that are most likely to give its goods a strong marketing push.

In many cases, distributors have competitive products or feel that they do not need to add any new product lines. If the multinational wants to tap into this distribution system, it will have to formulate an incentive programme that is designed to convince the distributor to carry its products. Some of the ways in which this is done include (1) helping to pay for local promotion campaigns of the product, (2) providing generous sales incentives, (3) conducting marketing research to identify customer niches and sales forecasts to help the distributor decide how much inventory to carry, and (4) ensuring that unsold or outmoded merchandise can be returned for a full refund.

Depending on the nature of the market and the competition, the multinational may give exclusive geographic distribution to one local seller or arrange to have a number of sellers jointly selling the product. For example, auto manufacturers often have more than one dealer in a major metropolis but are willing to give exclusive geographic distribution rights to dealers in rural areas. This is in contrast to food products that can be sold in a wide variety of outlets and for which exclusivity is unnecessary. In these cases the multinational will try to get a variety of distributors to carry the product.

STRATEGIC MANAGEMENT AND MARKETING STRATEGY

Marketing strategies play a key role in helping MNEs formulate an overall plan of action. Many approaches are directly related to the major areas that have been examined in this chapter, including ongoing market assessment, the use of effective pricing, internet marketing and 'open innovation'. Table 12.3 illustrates the worldwide market penetration of several MNEs to be discussed in this section.

Ongoing market assessment

One of the major areas that MNEs are continuing to pay attention to is data collection and analysis for the purpose of developing and updating market assessments. In some cases this causes multinationals to change their market approach, whereas in other cases it supports maintaining a current strategy.

Clarins

The French cosmetics firm Clarins SA is a good example of a firm that is continuing to refine its market strategy based on market assessment data. For more than two decades the company has been gathering feedback from customers on what they like and do not like about the firm's cosmetics. From these surveys the company has learned that women want makeup that is long lasting, easy to choose and easy to apply. This information has been invaluable in helping Clarins increase market share in an industry where competition is fierce. In fact, the company's growth rate in France has been more than twice the industry average, and Clarins is now achieving similar results in the US market. It is particularly interesting that this growth has

been achieved despite the cost of Clarins' products. For example, one of its facial hydrating formulas sells for over $50. Aware of what up-scale customers are willing to buy, Clarins has been very successful in using market assessment information to develop and market high-quality skincare products. One marketing consultant has referred to Clarins as a 'Body Shop for rich people'; certainly this target market has paid off well for the company.

Table 12.3 International market penetration: location of subsidiaries, holdings and joint ventures

General Motors (US)		Clarins (French)	Daewoo (Korean)	Mitsubishi Electric (Japanese)	Royal Dutch/Shell Group (Dutch/British)	
North America						
Canada		Canada	Canada	Canada	Canada	
Mexico		Mexico	Mexico	Mexico	Mexico	
US		US	US	US	US	
Western Europe						
Austria	Italy	Austria	France	Austria	Austria	Italy
Belgium	Luxembourg	Belgium	Germany	Belgium	Belgium	Luxembourg
Denmark	Netherlands	France	Greece	Denmark	Denmark	Netherlands
Finland	Norway	Germany	Ireland	Finland	Faroe Islands	Norway
France	Portugal	Italy	Italy	France	Finland	Portugal
Germany	Spain	Netherlands	Netherlands	Germany	France	Spain
Greece	Sweden	Portugal	Portugal	Greece	Germany	Sweden
Iceland	Switzerland	Spain	Spain	Iceland	Gibraltar	Switzerland
Ireland	Turkey	Switzerland	Sweden	Ireland	Greece	Turkey
	UK	UK	UK	Italy	Iceland	UK
				Luxembourg	Ireland	
				Netherlands		
				Norway		
				Portugal		
				Spain		
				Sweden		
				Switzerland		
				Turkey		
				UK		
Central and Eastern Europe						
Bulgaria	Malta	Russia	Croatia	Bulgaria	Bulgaria	Poland
Croatia	Montenegro		Czech Rep.	Croatia	Croatia	Romania
Cyprus	Poland		Hungary	Czech Rep.	Czech Rep.	Russia
Czech Rep.	Romania		Poland	Estonia	Estonia	Serbia
Estonia	Russian Fed.		Romania	Hungary	Hungary	Slovakia
Hungary	Serbia		Russia	Kazakhstan	Latvia	Slovenia
Latvia	Slovakia		Ukraine	Latvia	Lithuania	
Lithuania	Slovenia		Uzbekistan	Lithuania	Montenegro	
Macedonia				Montenegro		
				Poland		
				Romania		
				Russia		
				Serbia		
				Slovakia		
				Slovenia		
				Ukraine		
				Uzbekistan		
Asia and Oceania						
Australia		Hong Kong	Australia	Australia	Australia	Indonesia
China		Japan	Azerbaijan	Azerbaijan	Azerbaijan	Japan
Hong Kong		Malaysia	Bangladesh	China	Brunei	Kazakhstan
India		Singapore	China	Hong Kong	Cambodia	Malaysia
Indonesia		South Korea	Hong Kong	India	China	New Zealand
Japan		Taiwan	India	Indonesia	Fiji	Pakistan
Malaysia			Indonesia	Japan	Guam	Philippines
New Zealand			Japan	Malaysia	India	Singapore
Philippines			Malaysia	New Zealand		South Korea
Singapore			Myanmar	Pakistan		Sri Lanka
South Korea			Philippines	Philippines		Taiwan
Taiwan			Singapore	Singapore		Thailand
Thailand			South Korea	South Korea		Vietnam
Vietnam			Taiwan	Taiwan		
			Thailand	Thailand		
			Vietnam	Vietnam		
South America, Central America, and the Caribbean						
Argentina			Argentina	Argentina	Argentina	Guatemala
Brazil			Brazil	Brazil	Barbados	Honduras
Chile			Chile	Chile	Bolivia	Nicaragua
Colombia			Colombia	Colombia	Brazil	Panama
Ecuador			Panama	Panama	Chile	Peru
Uruguay			Peru	Peru	Colombia	Puerto Rico
Venezuela			Venezuela	Venezuela	Costa Rica	Surinam
					Dominican Rep. Ecuador	Trinidad & Tobago
					El Salvador	Venezuela
					French Antilles and Guiana	
Middle East						
Bahrain	Oman	UAE	Iran	Kuwait	Iran	Syria
Israel	Qatar		Iraq	Lebanon	Jordan	UAE
Jordan	Saudi Arabia		Israel	Saudi Arabia	Kuwait	Yemen
Kuwait	Syria		Jordan	UAE	Oman	
Lebanon	United Arab Emirates (UAE)		Libyan Arab Jamahiriya		Qatar Saudi Arabia	
			Saudi Arabia			
			UAE			
Africa						
Egypt			Algeria	Egypt	Algeria	Libya
South Africa			Angola	South Africa	Angola	Madagascar
			Egypt		Benin	Mali
			Kenya		Botswana	Mauritius
			Morocco		Burkina Faso	Morocco
			Nigeria		Cameroon	Mozambique
			South Africa		Cape Verde	Namibia
			Tunisia		Congo	Nigeria
					Côte d'Ivoire	Senegal
					Djibouti	South Africa
					Egypt	Sudan
					Ethiopia	Swaziland
					Gabon	Tanzania
					Gambia	Togo
					Ghana	Tunisia
					Guinea	Uganda
					Kenya	Zimbabwe
					La Rion	
					Lesotho	

Sources: Adapted from www.gm.com; www.shell.com; www.mitsubishi.com; www.clarins-financials.com; www.daewoo.com. All data from websites were available as of June 2010.

Shell Oil

Shell Oil is an MNE whose market assessment has showed the importance of not making significant changes in product or delivery systems. In recent years, Shell has limited its product diversification to tightly linked and synergistic energy and chemical businesses. The company has learned that it is most profitable when staying close to what it knows best. Today Shell works to balance its upstream (exploration and production), downstream (refining and marketing), and related chemical (industrial, agricultural and petrochemical) businesses. It is also developing a strong network of service stations around the world and has learned that its ability to assess situations and react quickly is an important element in its marketing strategy.

Shell is also famous as both an active user and a developer of scenario planning.[5] These were historically used to examine energy futures, in terms of supply and demand, as well as exploration opportunities and relative risks. But they have expanded to encompass a range of socio-political, economic and environmental trends, and the likelihood and impact of specific disruptive events. Shell is now used by many firms as a benchmark firm for tools and practices to help 'future-proof' strategies.

Effective pricing

Some MNEs use a high-price strategy and skim the cream off the top of the market. Others employ a low-price strategy designed to penetrate and capture a larger share of the middle and lower parts of the market. Depending on the nature of the market, both strategies can be successful.

Bang & Olufsen

Bang & Olufsen is a Danish electronics company that manufactures stereo components, televisions and video equipment. The firm targets the upper end of the market, selling to style-conscious consumers who are unlikely to flinch at paying $4,000 for an audio system, $7,100 for a wide-screen HDTV. One of the primary reasons customers buy from Bang & Olufsen is that the products are well engineered and designed. Televisions are sleek, thin and modern looking; stereo consoles are trim, polished and futuristic in design. But, rather than developing a stereotypical image as a provider of 'boys' toys', the firm focuses heavily on women's design preferences as more than half of all buying decisions are made by women (and they exert a strong influence on the other half). While many customers prefer to buy less stylish-looking products at one-third the price, Bang & Olufsen continues to have a steady stream of consumers who are willing to pay top dollar. Because of this, the company's worldwide sales in 2014 were approximately $350 million. See more about the company in **Real Case: Bang & Olufsen** below.

Internet marketing and 'open innovation'

The internet has become a central tool, not just for marketing but for market research and innovation, for many multinational firms. Because consumers, and industry buyers, increasingly use the internet to assess the portfolio of products and services offered by a company, websites have become critically important for marketing purposes. They provide a window into the quality, credibility, achievements and ethics of a firm, all of which underpin its corporate brand. Moreover, this now happens across a global platform that reaches more people in more countries than traditional marketing media such as radio or TV.

Some large multinationals have been highly adaptive in keeping pace with the development of more sophisticated online platforms. Many have

developed quite subtle positions in Facebook, for example, using these to promote specific products, but also convey a particular kind of image by interacting with young, early adopters on these kinds of user networks. This kind of online branding and marketing has evolved into a science of its own, partly because marketers have found online platforms play by different rules and often encourage a more liberal, unregulated environment than found in the 'real' world. British advertisers, including Vodafone, Virgin Media and insurance firm Prudential, withdrew adverts in the early days of Facebook when they found themselves next to the ultra right-wing British National Party (BNP), which was also promoting itself on the site.

✔ Active learning check

Review your answer to Active Learning Case question 4 and make any changes you like. Then compare your answer to the one below.

4 How does Adidas use online platforms and social media to promote its events, its sponsored athletes and its products?

Central to Adidas's marketing and promotion campaigns is the core principle that 'being talked about' is the key to engaging customers and selling products. Innovative product designs and creative advertising is part of this, but the firm also needs to maximise its investment in iconic sports stars by showcasing them as fashion role models. Like all big global brands it is increasingly sophisticated in its use of online platforms and social media to achieve these aims. Online videos and YouTube campaigns engage audiences in the lives of sponsored superstars on and off the pitch. Team GB at the 2012 London Olympics was the focus of attention through the #takethestage twitter campaign. The firm also used the online voting competition to name the 2014 FIFA World Cup official match ball to engage the national passion of the Brazilian hosts. For the 2016 Rio Games, Adidas mixed social media with a big brother experience. Women that were leading influencers and bloggers were hired by Adidas to share their experience about the games. These methods attract attention to the brand generally and to specific product launches or promotions which are timed to align with big sporting events. The firm then uses social media to track, often in real time, the effectiveness and uptake of the marketing messages and the associated designs or products. It also attempts to measure the engagement levels of audiences with particular sponsored personalities in order to develop how and when they should be used for different promotion purposes.

As shown by the Adidas and IKEA case studies above, firms have moved beyond using websites as one-way channels to present information and images to customers; now they are interactive portals for developing a better

understanding of, and relationship with, product and service ‘users.’ **Open innovation** is the term used to describe interactive, collaborative networks of product or service providers and customers. They allow users of products and services to help shape their development, and enable companies to design, develop and distribute them more efficiently, by building in user preferences.[6] The internet has proved to be ideal for developing open innovation platforms.

Shell, above, provides a good example. It has established Shell ‘GameChanger’[7] as an online venturing network to gather radically new ideas for innovations in the ‘energy and mobility’ industry. For the best ideas it can provide funds and contacts for would-be entrepreneurs and has a stage-gate process for assessing proof of concept into development. The firm is effectively using the internet to externalise part of its high-risk, blue-sky innovation activity.

Spreadshirt.com (www.spreadshirt.com) provides another good example. Rather than designing T-shirts and other clothing by second-guessing changing customer preferences, Spreadshirt invites customers to design their own online which can then be produced by the firm. This is similar to Dell’s value-chain business model, whereby customers can piece together a preferred desktop PC before ordering it. Spreadshirt’s production is outsourced abroad, so its main activity is to connect consumers with production processes. But, through the flow of design ideas coming from a global network of potential customers, it is able to: (1) achieve economies of scale by focusing on the standard clothing designs that attract the most customers; (2) assess changing customer markets, and changing market segments, as they evolve over time; and (3) innovate more efficiently by focusing resources on the best new product development opportunities.

It is important to understand the significance of these kinds of online activities as tools and techniques for helping solve some of the major

dilemmas facing all multinational managers. Key questions faced by market analysts are: How much do we need to customise our products or services for particular market segments (geographic, demographic, cultural, etc.) to maximise market share and profitability? What kinds of product, service, design, marketing and branding features can we standardise to optimise profitability? How are the preferences of different customer groups changing over time and where should we focus our innovation efforts? Open innovation and interactive internet networks, like the ones described above, can harness the direct input of (often unsuspecting) customers and users from all around the world to help solve these dilemmas.

KEY POINTS

1 Marketing strategy begins with an international market assessment: the evaluation of the goods and services the MNE can sell in the global marketplace. There are a number of steps in this process, including an initial screening that is designed to determine the basic need potential of the company's goods and services, followed by additional screenings that culminate in a final selection of those outputs that the company will market internationally.

2 Product strategies will vary depending on the specific good and the customer. Some products need little or no modification, and others require extensive changes. Some of the factors that influence the amount of modification include economics, culture, local laws and the product life cycle.

3 There are a number of ways in which MNEs promote their products, although the final decision is often influenced by the nature of the product. The two major approaches used in promotion are advertising and personal selling. Many multinationals try to use the same message worldwide because it is easier and more economical. However, this is not always possible because some messages either have no meaning in other languages or lack the impact of those in other markets. Similarly, while personal selling is used in some markets, in other markets the customer is unaccustomed to this promotion approach and non-personal approaches must be used, or the customer must be educated to accept this new form.

4 Pricing in international markets is influenced by a number of factors, including government controls, market diversity, currency fluctuations and price escalation forces.

5 Place strategy involves consideration of distribution, or the course goods will take between production and final consumer. This course often differs on a country-by-country basis, and MNEs will spend a considerable amount of time in examining the different systems in place, the criteria to use in choosing distributors and channels, and how distribution segmentation can be accomplished.

6 MNEs are using a variety of marketing strategies when formulating their strategic plans. Three of the most important strategies are ongoing market assessment, effective pricing internet marketing and 'open innovation'.

7 The internet has become an essential part of any firm's marketing and market analysis toolkit. It is also ideal for developing open innovation platforms to connect better with users and customers.

Key terms

- **international marketing**
- **international market assessment**
- **initial screening**
- **market indicators**
- **market size**
- **market intensity**
- **market growth**

- **trend analysis**
- **estimation by analogy**
- **regression analysis**
- **cluster analysis**
- **promotion**
- **advertising**
- **comparative advertising**
- **personal selling**
- **social media influencer**
- **distribution**
- **open innovation**

REVIEW AND DISCUSSION QUESTIONS

1. How does initial screening help an MNE evaluate those goods and services that might be sold in the international market? What are some ways in which this screening is carried out?
2. After an MNE has completed an initial screening of its goods and services, what other steps can it take in further refining the choice of those products to sell internationally? Briefly describe the remainder of the process.
3. Why can some goods and services be sold internationally without having to undergo much, if any, modification? Explain.
4. What factors influence the need for moderate to high modification of goods and services that have sold well in the home country and will now be marketed overseas? Identify and describe three of the most influential factors.
5. When should an MNE use the same promotion strategy overseas that it uses at home? When should it modify the approach?
6. Many MNEs find that their advertising messages can be used in overseas markets without much, if any, modification. Why is this so?
7. Why do MNEs sometimes have to modify their personal selling strategies when marketing their goods in international markets?
8. What kinds of factors influence the pricing of goods and services in the international marketplace? Identify and describe three.
9. Why do many MNEs find that they cannot use the same distribution strategy overseas that they have used at home?
10. In choosing the best distribution system, what types of criteria do MNEs use? Identify and discuss three.
11. In what ways are multinationals using the following concepts to help them gain greater international market share: ongoing market assessment, effective pricing, internet marketing and ‘open innovation’? In each case, offer an example.

12 Explain how open innovation networks using the internet can help firms decide on whether to customise or standardise product features.

REAL CASE

Bang & Olufsen

Introduction

Headquartered in Denmark and dating back to 1925, Bang & Olufsen (B&O) has evolved into the Rolls-Royce of the audio and visual industry. Producing luxury televisions, audio systems, loudspeakers and telephones, B&O claims to be in the unique position of having no direct competitors. As of 2017, B&O have 565 mono branded stores and 6,705 multi branded stores across 70 markets around the world. In 2018, B&O acquired approximately $495 million in revenue (Danish Krone (DKK) 3,285 million) and 51 per cent of this was in Europe, 18 per cent in China, 12 per cent in North America and 19 per cent from the rest of the world. With approximately 1,000 employees, B&O sells select high-end, luxury niche products at high prices. The customer is typically male, over 35 and affluent, but B&O has also identified three other customer groups including the young and educated, the design fanatic and the 'gray gold' couples whose children have left the nest.

However, against the backdrop of economic downturn, the company experienced a sharp decline in sales and incurred significant losses. In fiscal year 2009/10, the result was $453 million (DKK 2,762 million) in sales compared to approximately $610 (DKK 4,225 million) sales in 2005/6, reflecting a sales decline of around 34 per cent. The company derived only 3.2 per cent of its sales from foreign markets. Its revenue was 0.58 per cent of Sony's 2009 revenue of $77,696 million. A restructuring plan included 300 layoffs in Denmark on 21 October 2008, and the abandonment of the development of new cell phones, MP3 players and stand-alone systems like DVD2 and HDR2. The year 2009/10 also witnessed a decline in the company's B1 shops. At the end of May 2010, there were a total of 703 B1 shops across the world as against 758 shops at the end of the 2008/9 financial year. The company decided to focus on its traditional strengths: high-quality audio and video products as well as sound systems for the automotive industry.

The four Ps of B&O's marketing strategy are as follows.

Product strategies

B&O's approach to product development differs substantially from industry norms. Essentially, it is believed that consumers often are unaware of what they want. Instead, ideas are generated based on a deep understanding of how consumers live. Consumer research, corporate ethnographers and creative teams are replaced with the visions of a handful of contract designers who enjoy unprecedented decision-making power. All of the designers can veto anything failing to meet their visionary standards and, in the past, product design clearly took precedence over engineering capability. The popular BeoSound 9000 CD player was conceived without consulting B&O engineers, who needed two years to produce the technology making the design possible. That particular piece was designed by David Lewis, knighted by the Queen of Denmark for his work, while three of his B&O products are featured in the Museum of Modern Art's permanent collection in New York. Unlike those produced by Sony and Samsung, new B&O products come few and far between; in fiscal year 2009/10, only seven new models were released. Instead products tend to follow differing life cycles. Many are kept on the market for up to a decade even without lowering prices. For example, the BeoLab 8000 speakers, first introduced in 1992 at a price of $3,000 a pair, are now selling well at $4,500. The BeoSound 9000, introduced in 1996, continues to demand a price of $4,750. Cutting-edge technology, coupled with legendary design, make this possible. In addition, each B&O product is part of an interconnected system, allowing B&O to offer living room solutions that are centrally controlled. Although it has proved successful in the past, relying on only a handful of designers can be a risky proposition. Key designers are growing older, and finding replacements can be troublesome.

Promotion

Demand for B&O products is stimulated in a variety of ways; however, the general message of pristine quality and design is central. With an estimated $50 million (£32 million) global media planning and buying account, B&O promotes through varying advertising vehicles and also engages in advertiser-funded programming. Consequently, B&O products have appeared in *The Apprentice* as well as films such as *Thunderbirds* and *Charlie's Angels*. Most of B&O's selling takes place in the retail stores located in major cities across the globe. Here, well-to-do customers can experience the powerful products first hand, frequently in private sessions catered to their

needs. Lately B&O has engaged in symbiotic relationships with premium European car makers, supplying customised audio systems. The German car maker Audi was the first to offer the B&O sound system to its audience. The $6,155 option was expected to entice 100 Audi buyers in the first year. Instead, 15 per cent of A8 Audi buyers opted for it, resulting in the system being installed in almost 4,000 cars. This success led to valuable promotional exposure and one additional agreement with British car maker Aston Martin. Although ten other European auto makers have expressed interest in cooperation, B&O chooses its partners carefully so as to protect the premium image. The agreement with Aston Martin was a result of the recognition of a similar culture and heritage rooted in passion, performance, design and craftwork. B&O’s other B2B offerings also provide substantial exposure, stimulating consumer demand. Later, in 2007, B&O secured an agreement with the luxury Grand Lisboa hotel located in Macau, China. At this hotel alone, an estimated 50,000 tourists annually will be exposed to B&O TV and speaker systems.

Source: Francis Joseph Dean/Deanpictures/Corbis News/Getty Images

Place

B&O products have been described as art in the living room. They need space and air to be fully appreciated, which means that they must be presented to the public quite differently from lower-priced alternatives. Worldwide, B&O relies primarily on company-owned stores and private retailers featuring premium products. In recent years, these locations have relied more heavily on

customer databases to gain a better understanding of the individual customer. So far, B&O has resisted temptations of both the growing internet market and powerful big-box retailers, and instead continued to open company retail locations worldwide. Although selling premium solutions, B&O serves customers in both developed and developing economies worldwide. In fact, the two best-selling B&O retail locations are located in Moscow, where there exists a small set of extremely rich oligarchs. The emerging economies in Asia with otherwise low average incomes have also proven to be financially attractive due to the new millionaires and high-end luxury enterprises catering to world travellers. From the regional head office in Singapore, B&O is represented in ten countries in the Asia-Pacific region and its products are available from over 40 stores.

Price

Along with all other aspects of B&O communication with the public, selected retail prices match the general message of exclusivity. For example, retailing for $13,250, the 40-inch BeoVision 7 HDTV commands a premium price over other TV alternatives. The company targets a very limited segment (niche) of the world population, and can command these prices due to the documented premium quality and sustainability of its products. The substantial profit margin has the advantage of shielding the company against unfortunate economic conditions. In late 2007, the US dollar depreciated substantially against the world's premier currencies. If prices are left unchanged, this translates directly into lower profits for foreign companies operating in the United States and exchanging dollars into home currency. In the case of B&O, a substantial part of sourced components originated from the United States, which meant that production costs decreased accordingly.

Conclusion

In the coming years, B&O hopes to grow its market share by focusing on its niche. In doing so, the company must carefully consider what action to take and what message product, place, promotion and price should send to make its goal a reality.

Websites: www.beoworld.org; www.bang-olufsen.com

Sources: 'COO discusses Bang & Olufsen's opportunity to benefit from improving market conditions', twist.com, 3 March 2004; 'Bang & Olufsen joins forces with Aston Martin for creative partnership', *Wireless News*, 16 December 2007; Tony Lewin, 'Top marques turn to branded audio', *Automotive News Europe*, 1 October 2007; 'Danish B&O eyes more automotive partnership deals in 2008', *Danish News Digest*, 11 December 2007; Gwendolyn Bounds, 'A way to fight big rivals: play up style, service', *The Capital (Annapolis)*, 1 April 2007; Leo Jakobson, 'Divine designs', *Incentive*, 12 September 2007; Christopher Lim, 'Bang & Olufsen hot on customization', *Business Times Singapore*, 22 September 2007; 'Denmark: B&O will double its size', *Esmerk Danish News*, 26 September 2007; Adeline Paul Raj, 'Bang & Olufsen to jazz up image', *Business Times*, 29 November 2007; Ian Darby, 'Bang & Olufsen reviews £50m global media', *Campaign*, 14 April 2006; Jay Greene, 'Where designers rule', *Business Week*, 5 November 2007; Bang & Olufsen, *Annual Report*, 2009/10, 2017/18.

1 Why does Audi use B&O equipment in its high-end cars?

2 How does B&O combine actions on product, place, promotion and price?

3 How can B&O double its market share by expanding on its successful niche in the future?

REAL CASE

Mirum – never lose your sense of wonder!

It is a complex time to be a big player in the global marketing communications ('marcomms') industry. The explosion of digital media means that every marketing idea is scrutinised by a variety of influencers with voracious demands for content, media outlets are merging overnight, and social media technologies are expanding rapidly. Multi-agency networks, like JWT, face the challenge of improving profitability through strategic integration.

Strategic integration, however, is hard to achieve. In principle, it entails exploiting the growth potential of the network by fully combining resources and competencies from business units or brands and directing those units towards new business opportunities that extend the existing corporate strategy of the network as a whole. In practice, how this is achieved is quite a delicate exercise in convergence, mainly because increased demands for transparency and authenticity mean that companies must speak with one voice to clients and markets. To stay ahead of the game in this industry, global marcomms networks have been converging rapidly as they continuously re-engineer to focus on the capabilities that would improve their speed, quality, efficiency and responsiveness – and pruning business activities that no longer fit the value-creation logic of their corporate strategy.

In 2015, JWT, who had approximately 10,000 employees, made a similar attempt by creating a global multi-agency digital network called Mirum. Prior to Mirum, JWT had acquired a variety of digital agencies the world over. Each of these agencies was a leader in its respective market, each hosting distinct talents and skills. JWT, however, struggled to bring them to work together – conflicting reporting lines, mixed digital fluency and a complex digital landscape meant that it could not afford to deliver a siloed approach to communications. It had to find a single voice to bind them all, sharing common values, technological skills and the ultimate desire to transform businesses through digital communications solutions.

Mirum was created to integrate JWT's digital expertise and promote greater agility and exchange between all agencies involved. Its website describes it as:

a new agency created with a pioneering spirit, built by bringing together successful regional companies that have a deep understanding of local market needs. Our principles are rooted in innovation, design, data marketing and technology to drive business transformation in a world of constantly evolving behaviours and expectations. Operating in 17 countries, with 40 offices and more than 2,200 professionals, Mirum is a global agency that is a part of the J. Walter Thompson Company and WPP family.

Mirum's capabilities are organised around 'Strategy & Consulting' services, 'Creative & Content', 'User Experience & Platforms', 'Analytics & Insight', and 'Product Development & Mobile'. Additionally, Mirum is able to provide deep vertical service offerings in Digital Retail, Behavioral Media and Financial Services. Mirum allowed JWT to provide more access to talent from around the globe, enabling the agency to tap into the expertise of different niches, while been able to deliver both the technology and innovative solutions that global brands demand. At the end of 2018, JWT merged with digital agency Wunderman to form 'Wunderman Thompson', who now own Mirum. As of 2019, Mirum Operates in 17 countries, with 40 offices and employs more than 2,200 professionals. Some of Mirum's client include include CBRE, Cyrela, Daum Kakao, Finnair, HSBC, Magazine Luiza, Mazda, Microsoft, Nokia, Petco, Singapore Tourism Board, TD Bank, Walmart and XL. Moreover, some of Mirum's companies include Digitaria (US), XM (Asia Pacific), CASA (Brazil), ActivearkJWT (Finland, Sweden, India, UK) and Twist Image (Canada), Lunchbox (US), i-Cherry (Brazil), HeathWallace (UK), Quirk (South Africa, UK), Clarus (Mexico) and X-Prime (France).

Websites: http://strategyonline.ca/201501/30/twist-image-to-become-mirum/; http://www.wpp.com/wpp/press/2015/jan/29/introducing-mirum-a-modern-global-company/; https://www.jwt.com/en/mirum/; http://www.mirumagency.com/london; https://www.mirumagency.com/en/news/-what-wunderman-thompson-means-for-mirum; https://www.mirumagency.com/en/news/introducing-mirum-modern-global-company

Source: R. A. Burgelman and Y. L. Doz, 'The power of strategic integration', *MIT Sloan Management Review* (spring 2001); T. Zenger, 'Trial and error is no way to make strategy',

Harvard Business Review, vol. 19, no. 4 (April 2015).

1 Explain what was JWT's rationale in the creation of Mirum?

2 How does JWT benefit from the creation of Mirum?

NOTES

1 See, for example, Graham Hooley, John Saunders, Nigel F. Piercy and Brigitte Nicoulaud, *Marketing Strategy and Competitive Positioning*, 6th ed. (Harlow: Pearson, 2017).
2 Daniel W. Baack et al., *International Marketing*, 2nd ed. (Sage publications, 2018).
3 Philip Kotler and Gary Armstrong, *Principles of Marketing,* 17th ed. (Harlow, Pearson, 2017).
4 See Hooley et al., *Marketing Strategy and Competitive Positioning*.
5 For a wealth of resources, see www.shell.com/scenarios.
6 Henry William Chesbrough, *Open Innovation: The New Imperative for Creating and Profiting from Technology* (Boston, MA: Harvard Business School Press, 2003).
7 See https://www.shell.com/energy-and-innovation/innovating-together/shell-gamechanger.html

BIBLIOGRAPHY

Alexander, Nicholas, Rhodes, Mark and Myers, Hayley. 'International market selection: measuring actions instead of intentions', *Journal of Services Marketing*, vol. 21, no. 6 (2007).

Almodovar, Paloma and Rugman, Alan M. 'The regionalization and performance of standardizing versus customizing firms', Henley Business School, University of Reading, Dunning Center for International Business Discussion Paper Series, mimeo (2011).

Aspelund, Arild, Madsen, Tage Koed and Moen, Øystein. 'A review of the foundation, international marketing strategies, and performance of international new ventures', *European Journal of Marketing*, vol. 41, nos. 11/12 (2007).

Auger, Pat, Devinney, Timothy M., Louviere, Jordan J. and Burke, Paul F. 'The importance of social product attributes in consumer purchasing decisions: a multi-country comparative study', *International Business Review*, vol. 19, no. 2 (April 2010).

Baack, Daniel W. et al., *International Marketing*, 2nd Ed. (Sage Publications, 2018).

Bahadir, S. Cem, Bharadwaj Sundar G. and Srivastava, Rajendra K. 'Marketing mix and brand sales in global markets: Examining the contingent role of country-market characteristics', *Journal of International Business Studies*, vol. 46, no. 5 (2015).

Boehe, Dirk M. 'Captive offshoring of new product development in Brazil', *Management International Review*, vol. 50, no. 6 (2010).

Broderick, Amanda J., Greenley, Gordon E. and Mueller, Rene Dentiste. 'The behavioral homogeneity evaluation framework: multi-level

evaluations of consumer involvement in international segmentation', *Journal of International Business Studies*, vol. 38, no. 5 (September 2007).

Chabowski, Brian R., Samiee, Saeed and Hult, G. Tomas M. 'A bibliometric analysis of the global branding literature and a research agenda', *Journal of International Business Studies*, vol. 44, no. 6 (2013).

Chatzipanagiotou, Kalliopi, Christodoulides, George and Veloutsou, Cleopatra. 'Managing the consumer-based brand equity process: A cross-cultural perspective', *International Business Review*, vol. 28, no. 2 (2019).

Ellis, Paul D. 'Is market orientation affected by the size and diversity of customer networks?', *Management International Review*, vol. 50, no. 3 (2010).

Eng, Teck-Yong and Spickett-Jones, J. Graham. 'An investigation of marketing capabilities and upgrading performance of manufacturers in mainland China and Hong Kong', *Journal of World Business*, vol. 44, no. 4 (2009).

Gabrielsson, Peter, Gabrielsson, Mika and Gabrielsson, Hannele. 'International advertising campaigns in fast-moving consumer goods companies originating from a SMOPEC country', *International Business Review*, vol. 17, no. 6 (December 2008).

Grewal, Dhruv, et al. 'Evaluation of subsidiary marketing performance: combining process and outcome performance metrics', *Journal of the Academy of Marketing Science*, vol. 37, no. 2 (2009).

Griffith, David A., Yalcinkaya, Goksel and Calantone, Roger J. 'Do marketing capabilities consistently mediate effects of firm intangible capital on performance across institutional environments?', *Journal of World Business*, vol. 45, no. 3 (2010).

Heinberg, Martin, Ozkaya, H. Erkan and Taube, Markus. ‘The influence of global and local iconic brand positioning on advertising persuasion in an emerging market setting’, *Journal of International Business Studies*, vol. 48, no. 8 (2017).

Hooley, Graham, Saunders, John, Piercy, Nigel F. and Nicoulaud, Brigitte, *Marketing Strategy and Competitive Positioning*, 6th ed. (Harlow: Pearson, 2017).

Il Park, Byung, Whitelock, Jeryl and Giroud, Axèle. ‘Acquisition of marketing knowledge in small and medium-sized IJVs: The role of compatibility between parents’, *Management Decision*, vol. 47, no. 8 (2009).

Jiménez, Nadia Huitzilin and San Martín, Sonia. ‘The role of country-of-origin, ethnocentrism and animosity in promoting consumer trust: the moderating role of familiarity’, *International Business Review*, vol. 19, no. 1 (February 2010).

Kanso, Ali M. and Nelson, Richard Alan. ‘Multinational corporations and the challenge of global advertising’, *International Marketing Review*, vol. 24, no. 5 (2007).

Kotler, Philip and Armstrong, Gary, *Principles of Marketing*, 17th ed. (Harlow, Pearson, 2017).

Kumar, Ajay and Paul, Justin. ‘Mass prestige value and competition between American versus Asian laptop brands in an emerging market – theory and evidence’, *International Business Review*, vol. 27, no. 5 (2018).

Lim, Lewis K. S., Acito, Frank and Rusetski, Alexander. ‘Development of archetypes of international market strategy’, *Journal of International Business Studies*, vol. 37, no. 4 (July 2006).

Magnusson, Peter, Westjohn, Stanford A. and Sirianni, Nancy J. ‘Beyond country image favorability: How brand positioning via country

personality stereotypes enhances brand evaluations', *Journal of International Business Studies*, vol. 50, no. 3 (2019).
Ngo, Liem Viet and O'Cass, Aron. 'Performance implications of market orientation, marketing resources, and marketing capabilities', *Journal of Marketing Management*, vol. 28, no. 1–2 (2012).
Okazaki, Shintaro and Taylor, Charles R. 'Social media and international advertising: theoretical challenges and future directions', *International Marketing Review*, vol. 30, no. 1 (2013).
Papu, Ravi, Quester, Pascale G. and Cooksey, Ray W. 'Country image and consumer-based brand equity: multi-level evaluations of consumer involvement in international segmentation', *Journal of International Business Studies*, vol. 38, no. 5 (September 2007).
Powers, Thomas L. and Loyka, Jeffrey J. 'Market, industry, and company influences on global product standardization', *International Marketing Review*, vol. 24, no. 6 (2007).
Roy, Subhadip, Guha, Abhijit, Biswas, Abhijit and Grewal, Dhruv. 'Celebrity endorsements in emerging markets: Align endorsers with brands or with consumers?.' *Journal of International Business Studies*, vol. 50, no. 3 (2019), pp. 295–317.
Ripollés, Maria and Blesa, Andreu. 'International new ventures as 'small multinationals': the importance of marketing capabilities', *Journal of World Business*, vol. 47, no. 2 (2012).
Rubera, Gaia, Ordanini, Andrea and Griffith, David A. 'Incorporating cultural values for understanding the influence of perceived product creativity on intention to buy: an examination in Italy and the US', *Journal of International Business Studies*, vol. 42 (2011).
Rugman, Alan M., Oh, Chang H. and Lim, Dominic S. K. 'The regional and global competitiveness of multinational firms', *Journal of the Academy of Marketing Science* (2011).

Samiee, Saeed. ‘Brand origin recognition accuracy: its antecedents and consumers’ cognitive limitations’, *Journal of International Business Studies*, vol. 36, no. 4 (July 2005).

Sarstedt, Marko, Wilczynski, Petra and Melewar, T. C. ‘Measuring reputation in global markets – A comparison of reputation measures’ convergent and criterion validities’, *Journal of World Business*, vol. 48, no. 3 (2013).

Schmid, Stefan and Kotulla, Thomas. ‘50 years of research on international standardization and adaptation: from a systematic literature analysis to a theoretical framework’, *International Business Review*, vol. 20, no. 5 (October 2011).

Sharma, Piyush. ‘Country of origin effects in developed and emerging markets: exploring the contrasting roles of materialism and value consciousness’, *Journal of International Business Studies*, vol. 42, no. 2 (February/March 2011).

Singh, Jagdip, Lentz, Patrick and Nijssen, Edwin J. ‘First- and second-order effects of consumers’ institutional logics on firm consumer relationships: a cross market comparative analysis’, *Journal of International Business Studies*, vol. 42, no. 2 (February/March 2011).

Solberg, Carl Arthur and Durrieu, François. ‘Access to networks and commitment to internationalization as precursors to marketing strategies in international markets’, *Management International Review*, vol. 46, no. 1 (2006).

Taylor, Charles R. and Okazaki, Shintaro. ‘Who standardizes advertising more frequently, and why do they do so? A comparison of U.S. and Japanese subsidiaries’ advertising practices in the European Union’, *Journal of International Marketing*, vol. 14, no. 1 (2006).

Veale, Roberta and Quester, Pascale. ‘Do consumer expectations match experience? Predicting the influence of price and country of origin on

perceptions of product quality’, *International Business Review*, vol. 18, no. 2 (April 2009).

Vorhies, Douglas W. and Morgan, Neil A. ‘Benchmarking marketing capabilities for sustainable competitive advantage’, *Journal of Marketing*, vol. 69, no. 1 (2005).

Wan, Wendy W.N., Luk, Chung-Leung and Chow, Cheris W.C. ‘Consumer responses to sexual advertising: The intersection of modernization, evolution, and international marketing’, *Journal of International Business Studies*, vol. 45, no. 6 (2014).

Wu, Jie. ‘Marketing capabilities, institutional development, and the performance of emerging market firms: a multinational study’, *International Journal of Research in Marketing*, vol. 30, no. 1 (2013).

Yang, Deli and Fryxell, Gerald E. ‘Brand positioning and anti-counterfeiting effectiveness’, *Management International Review*, vol. 49, no. 6 (2009).

Zeugner Roth, Katharina Petra, Diamantopoulos, Adamantios and Montesinos, M. Ángeles. ‘Home country image, country brand equity and consumers’ product preferences: an empirical study’, *Management International Review*, vol. 48, no. 5 (2008).

Chapter 13

HUMAN RESOURCE MANAGEMENT STRATEGY

Contents

Objectives of the chapter

Human resource management strategy provides an MNE with the opportunity to truly outdistance its competition. For example, if HP develops a laser printer that is smaller, lighter and less expensive than competitive models, other firms in the industry will attempt to reverse-engineer this product to see how they can develop their own version. However, when a multinational has personnel who are carefully selected, well trained and properly compensated, it has a pool of talent that the competition may be unable to beat. Products and brands may, to some extent, be imitable; knowledge and capabilities, and the processes that combine and leverage them for competitive advantage, tend not to be. For this reason, human resource management (HRM) is a critical element of international management strategy. This chapter considers the ways in which multinationals prepare their people to take on the challenges of international business. We focus specifically on such critical areas as selection, training, managerial development, compensation and labour relations.

The specific objectives of this chapter are to:

1 *Define* the term *international human resource management* and discuss human resource strategies in overseas operations.

2 *Describe* the screening and selection criteria often used in choosing people for overseas assignments.

3 *Relate* some of the most common types of training and development that are offered to personnel who are going overseas.

4 *Discuss* the common elements of an international compensation package.

5 *Explain* some of the typical labour relations practices used in the international arena.

6 *Describe* some of the human resource management strategies that are currently receiving a great deal of attention from MNEs.

ACTIVE LEARNING CASE

The Coca-Cola Company thinks local

The Coca-Cola Company has been operating internationally for most of its 130-year history, since it first started operations in Canada in 1906. With revenues amounting to $31.9 billion in 2018, the company operates in 200 countries and employs over 60,000 people. In total, Coca-Cola owns or licenses over 500 non-alcoholic beverage brands, which belong to the following categories: sparkling soft drinks; water, enhanced water and sports drinks; juice, dairy and plant-based beverages; tea and coffee; and energy drinks. In terms of units sold, in 2018, approximately 30 per cent of its sales were in Europe, Middle East and Africa, 27 per cent from Latin America, 23 per cent for Asia-Pacific and 20 per cent from North America. Its human resource management (HRM) strategy helps explain a great deal of its success. The organisation follows a strategy of 'national responsiveness' by adapting to local market conditions. For example, it transferred more than 300 professional and managerial staff from one country to another under its leadership development programme, and the number of international transferees is increasing annually. One senior-level HRM manager explained Coca-Cola's strategy by noting:

> We recently concluded that our talent base needs to be multilingual and multicultural . . . To use a sports analogy, you want to be sure that you have a lot of capable and competent *bench strength*, ready to assume broader responsibilities as they present themselves.

In preparing for the future, Coca-Cola includes a human resource recruitment forecast in its annual and long-term business strategies. It also has selection standards on which management can focus when recruiting and hiring. For example, the company likes applicants who are fluent in more than one language because they can be transferred to other geographic areas where their fluency will help them to be part of Coca-Cola's operation.

The firm also has a recruitment programme that helps it identify candidates at the college level. Rather than just seeking students abroad, Coca-Cola looks for foreign students who are studying in the United States at domestic universities. The students are recruited in the United States and then provided with a year's training before they go back to their home country. Coca-Cola also has an internship programme for foreign students who are interested in working for the company during

school breaks, either in the United States or back home. These interns are put into groups and assigned a project that requires them to make a presentation to the operations personnel, including a discussion of what worked and what did not. The interns are then evaluated individually and management decides their future potential with the company.

Coca-Cola believes these approaches are extremely useful in helping to find talent on a global basis. Not only is the company able to develop internal sources, but its intern programme provides a large number of additional individuals who would otherwise end up with other companies. Coca-Cola earns a greater portion of its income and profit overseas than it does in the United States. Its HRM strategy helps explain how, despite the success of its policies, Coca-Cola found itself facing a series of problems as it entered the millennium. During the 1980s the firm expanded its global reach and began to centralise control and encourage consolidation among all bottling partners. In the 1990s, however, the world began to change. Many national and local leaders began seeking sovereignty over their political, economic and cultural futures. As a result, the very forces that were making the world more connected and homogeneous were also triggering a powerful desire for local autonomy and the preservation of unique cultural identity. Simply put, the world was demanding more nimbleness, responsiveness and sensitivity from MNEs, while Coca-Cola was centralising decision making, standardising operating practices, and insulating itself from this changing environment. It was going global when it should have been going local.

Former CEO, Neville Isdell, helped Coca-Cola turn around during the late 2000s by focusing on marketing-led growth. In particular, he helped Coca-Cola implement three principles designed to make it more locally responsive. First, it is instituting a strategy of ‘Think local, act local’ by putting more decision making in the hands of local managers. Second, it is focusing itself as a pure marketing company that pushes its brands on a regional and local basis. Third, it is working to become a model citizen by reaching out to the local communities and getting involved in civic and charitable activities. In the past, Coca-Cola succeeded because it understood and appealed to global commonalities; in the future it hopes to succeed by better understanding and appealing to local differences.

Websites: www.cocacola.com; www.cokecce.com

Sources: 'The veteran', *The Economist*, 2 June 2007; Coca Cola, *Annual Report*, 2010, 2014, 2017. Thomson Reuters, *OneSource*, 2011; Coca Cola 2018 Business & Sustainability Report.

1. **Does the Coca-Cola Company have a local perspective regarding the role of human resource management?**
2. **On what basis does Coca-Cola choose people for international assignments? Identify and describe two.**
3. **What type of training does Coca-Cola provide to its interns? Of what value is this training?**
4. **How useful is it for Coca-Cola's managers to be fluent in more than one language? Why?**

INTRODUCTION

International human resource management (IHRM) is the process of selecting, training, developing and compensating personnel in overseas positions. This chapter will examine each of these activities. Before doing so, however, it is important to clarify the general nature of this overall process, which begins with selecting and hiring.

There are three basic sources of personnel talent that MNEs can tap for positions.[1] One is **home-country nationals**, who reside abroad but are citizens of the multinational's parent country. These individuals are typically called **expatriates**. An example is a US manager assigned to head an R&D department in Tokyo for IBM Japan. A second is **host-country nationals**, who are local people hired by the MNE. An example is a British manager working for Ford Motor Company in London. The last is **third-country nationals**, who are citizens of countries other than the one in which the MNE is headquartered or the one in which it has assigned them to work. An example is a French manager working for Sony in the United States.

Staffing patterns may vary depending on the length of time the MNE has been operating. Many MNEs will initially rely on home-country managers to staff their overseas units, gradually putting more host-country nationals into management positions as the firm gains experience. Another approach is to use home-country nationals in less developed countries and employ host-country nationals in more developed regions, a pattern that is fairly prevalent among US and European MNEs. A third pattern is to put a new operation under the supervision of a home-country manager but turn it over to a host-country manager once it is up and running. Figure 13.1 provides an illustration of the types of managers, by nationality mix, required over the

stages of internationalisation. When an MNE is exporting into a foreign market, host-country nationals will handle everything. As the firm begins initial manufacture in that country, the use of expatriate managers and third-country nationals begins to increase. As the company moves through the ensuing stages of internationalisation, the nationality mix of the managers in the overseas unit continues to change to meet the shifting demands of the environment.

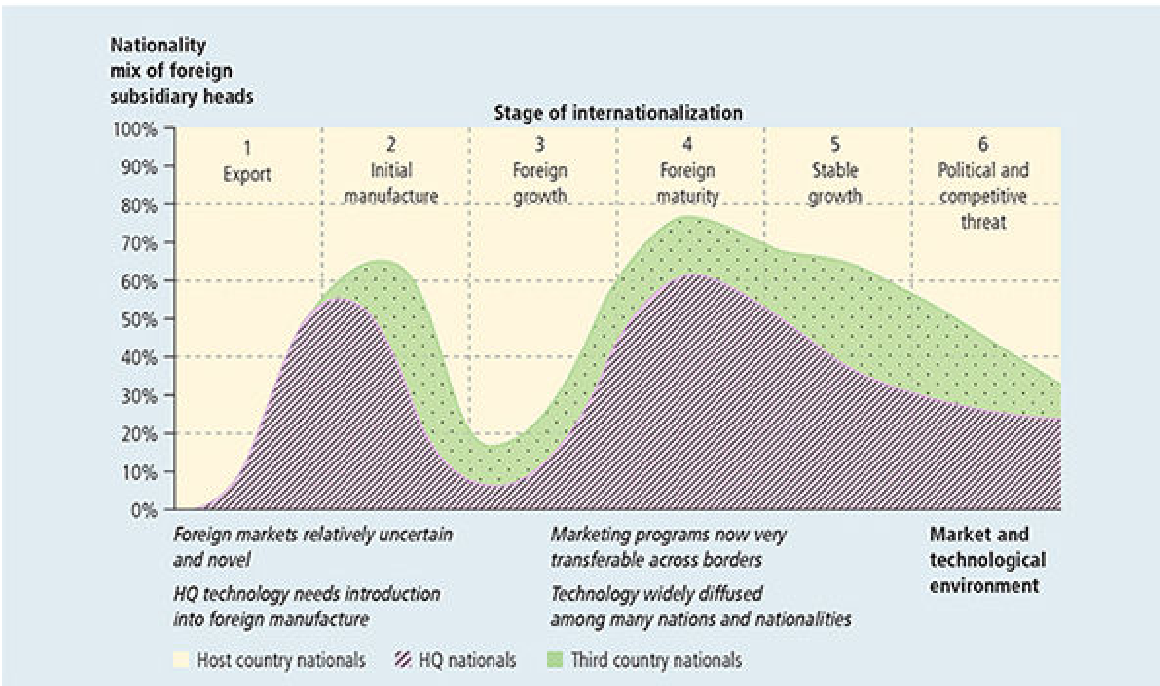

Figure 13.1 The management of multinational enterprises

Source: Adapted from *Colombia Journal of World Business*, Summer 1973, Lawrence G. Franco, "Who manages multinational enterprises?" p. 33 Elsevier Science.

In some cases, staffing decisions are handled uniformly. For example, most Japanese MNEs rely on home-country managers to staff senior-level positions. Similarly, some European MNEs assign home-country managers to overseas units for their entire careers. US MNEs typically view overseas assignments as temporary, so it is more common to find many of these expatriates working under the supervision of host-country managers.

The size of the compensation package also plays an important role in personnel selection and placement. As the cost of sending people overseas has increased, there has been a trend towards using host-country or third-country nationals who know the local language and customs. For example, many US multinationals hired English or Scottish managers for the top positions at subsidiaries in former British colonies such as Jamaica, India, the West Indies and Kenya in the early days of their international expansion.

The above factors influence IHRM strategies and help MNEs integrate an international perspective into their human resource policies and practices.[2]

Active learning check

Review your answer to Active Learning Case question 1 and make any changes you like. Then compare your answer to the one below.

1 **Does the Coca-Cola Company have a local perspective regarding the role of human resource management?**

The company certainly does have a local perspective regarding the HRM role. Coca-Cola is interested in recruiting people from anywhere in the world, training and developing them, and sending them to assignments around the globe. It does not confine itself to recruiting, training, developing or promoting people from any one particular region or country. Both Americans and non-Americans have equal opportunities in the company, further reinforcing this international perspective.

SELECTION AND REPATRIATION

Two of the major HRM challenges facing MNEs are those of selecting qualified people for overseas assignments and, in the case of home-country nationals, effectively repatriating them into the workforce upon their return. Each presents a significant challenge.

International screening criteria and selection procedures

International screening criteria are those factors used to identify the individuals regarded as most suitable for overseas assignment. Some MNEs use an extensive list, whereas others rely on only a handful of factors. A number of screening criteria are commonly used in determining whom to send overseas. These criteria focus on both individual and family considerations.

Adaptability

One criterion is an individual's ability to adapt to cultural change. Research shows that many managers are initially pleased to learn they are being sent overseas. However, within a few months many of them begin to suffer from culture shock brought on by the large number of changes to which they are subjected. This often results in a decline in job satisfaction. However, as they continue their overseas assignment, satisfaction goes back up. Research by Torbiorn as long ago as 1982, for example, reported that by the end of the first year most managers are through the cultural change phase and are beginning to adjust to their new conditions. Among those who stay overseas for two or more years, Torbiorn found that satisfaction reaches new heights and continues rising.[3] This general pattern has not changed as much as we might think. Researchers have also found that men tend to adjust slightly faster than

women, and that people over the age of 35 have somewhat higher levels of satisfaction after the first year.

In determining how well an individual will adapt to cultural change, MNEs examine a number of characteristics, including (1) work experiences with cultures other than one's own, (2) previous overseas travel, (3) knowledge of foreign languages (fluency is not generally necessary), (4) the ability to solve problems within different frameworks and from different perspectives, and (5) overall sensitivity to the environment.

Self-reliance

Managers who are posted to overseas assignments must be self-reliant and independent because they often have to make on-the-spot decisions without consulting the home office. In determining self-reliance, MNEs evaluate the amount of field experience the individual has had, as well as experience in special projects and task forces – assignments that often require and nurture self-reliance. Consideration is also given to hobbies or avocations that require a high degree of personal independence.

Age, experience and education

MNEs often find that young managers are eager for international assignments and want to learn more about other cultures. On the other hand, older managers have more experience and maturity to bring to the assignment. To balance the strengths of the two groups, many firms send both young and seasoned personnel to the same overseas post so that each can learn from the other.

Some MNEs believe that a college degree, preferably a graduate degree, is important for international managers. However, there is no universal agreement on this point. Multinationals who sell highly technical products tend to prefer people with science degrees. Others hold that a good education

helps develop logical thinking, creative ideas and a broad perspective of the world, so they prefer individuals with a liberal arts education.

Health and family status

Expatriates must have good physical and emotional health. Those with physical problems that will limit their activities are screened from consideration. So are those judged less likely to withstand culture shock.

Multinationals also take into account a person's family situation. An unhappy family life will hurt employee productivity. One survey of US multinationals found that the primary reason for expatriate failure was the inability of the manager's spouse to adjust to a different physical or cultural environment. For this reason, some firms interview both the spouse *and* the manager before deciding whether to approve the assignment.[4]

The increasing number of dual-career families in Western countries creates a further challenge for MNEs. Equally career-minded spouses might find their careers interrupted during their spouses' overseas assignments. In fact, a study of 332 repatriates and spouses found most dissatisfaction with MNEs resulted from lack of employment support for the trailing spouse.[5]

Motivation and leadership

Another selection criterion is the individual's desire to work abroad and potential commitment to the new job. Many people who are unhappy with their position at home will consider an overseas assignment, but this is not sufficient motivation. Motivational factors include a desire for adventure, a pioneering spirit, a desire to increase one's chances for promotion and the opportunity to improve one's economic status.[6]

Additionally, one group of researchers recently examined the factors associated with employee willingness to work overseas and concluded the following:

- Unmarried employees are more willing than any other group to accept expat assignments.
- Married couples without children at home or those with non-teenage children are probably the most willing to move.
- Prior international experience seems associated with willingness to work as an expatriate.
- Individuals most committed to their professional careers and to their employing organisations are prone to be more willing to work as expatriates.
- Careers and attitudes of spouses will likely have a significant impact on employee willingness to move overseas.

Employee and spouse perceptions of organisational support for expats are also critical to employee willingness to work overseas.

Applicants are also evaluated on the basis of their leadership potential, since most expatriates end up supervising others. Although this is a difficult factor to assess, a number of characteristics are commonly sought when making this evaluation, including maturity, emotional stability, the ability to communicate well, independence, initiative and creativity. These characteristics are good indications of leadership potential.

Selection procedures

The most common selection procedure is the interview. A general consensus is that extensive interviews of candidates and their spouses by senior executives still ultimately provide the best method of selection. For example, 52 per cent of the US MNEs that Tung (1982) surveyed conducted interviews with both the manager and the spouse, whereas 47 per cent conducted interviews with the candidate alone. In the case of technically oriented positions, these percentages were 40 and 59 per cent. Other MNEs follow a similar pattern. Based on her research, Tung has concluded that multinationals

are becoming increasingly cognisant of the importance of interviewing in effective performance abroad.

Some companies also use tests to help in making the final choice of who will perform well in overseas assignments. However, this approach has not gained a great deal of support because it is expensive and many MNEs feel that tests do not improve the selection process. As a result, the candidate's domestic record and evaluations from superiors and peers, along with the interview, tend to be relied on most heavily.

Repatriation of expats

Repatriation is the process of returning home at the end of an overseas assignment. Managers are repatriated for a number of reasons. The most common one is that the predetermined time assignment is completed. For expatriates, an overseas assignment usually lasts two to three years, although some companies are now encouraging their people to consider making the international arena a lifetime career choice. Another reason is the desire to have their children educated in the home country. The expatriate may be unhappy overseas and the company may feel there is more to be gained by bringing the person back than in trying to persuade the individual to stay on. Finally, as in any position, if a manager has performed poorly, the MNE may decide to put someone else in the position.

Readjusting

Although many expatriates look forward to returning, some find it difficult to adjust. A number of reasons can be cited. One is that the home-office job lacks the high degree of authority and responsibility the expat had in the overseas job. Another is that the expat feels the company does not value international experience and the time spent overseas seems to have been wasted in terms of career progress. A third reason is a change in the standard

of living. While overseas, many expats have generous living allowances and benefits that they cannot match back home. An accompanying problem is the change in cultural lifestyle. For example, a person who is transferred from a cosmopolitan city such as Vienna to a small town in Middle America may find it necessary to make major adjustments, ranging from social activities to the pace of life in general. Additionally, it is common to find that those who sold their house before leaving and have been overseas from three to five years are stunned by the high price of a replacement home. Not only have they lost a great deal of equity by selling, but they must also come up with a substantial down payment and much larger monthly mortgage payments. Some companies do not have plans for handling returning managers. If these individuals are assigned jobs at random, they can find their career progress jeopardised.

Recent research shows that the longer people remain overseas, the more problems they are likely to have being reabsorbed into the operations back home. In addition to the factors considered above, several factors make repatriation of such people after longer periods difficult: (1) they may no longer be familiar to people at headquarters; (2) their old jobs may have been eliminated or drastically changed; or (3) technological advances at headquarters may have rendered their existing skills and knowledge obsolete. In many cases, it takes from 6 to 12 months before a returning manager is operating at full effectiveness.

Adjustment strategies

In recent years, MNEs have begun to address adjustment problems faced by returning expatriates. Some have now developed **transition strategies** that are designed to help smooth the move from foreign to domestic assignments.

One of these strategies is the **repatriation agreement**, which spells out how long a person will be posted overseas and sets forth the type of job the

person will be given upon returning. The agreement typically does not spell out a particular position or salary, but it does promise a job that is at least equal in authority and compensation to the one that the person held overseas. Such an agreement relieves a great deal of the anxiety expatriates encounter because it assures them that the MNE is not going to forget them while they are gone and that there will be a place for them when they return.

A second strategy is to rent or maintain the expatriate's home during the overseas tour. Both Union Carbide and the Aluminum Company of America have such arrangements. These plans help reduce the financial burden managers face when they go on a three- or four-year tour.

A third strategy is to assign a senior executive as a sponsor for every manager posted abroad. This ensures that there is someone looking after each expatriate and ensuring that his or her performance, compensation and career path are on track. When the expatriate is scheduled to return home, the sponsor begins working internally to ensure a suitable position. Companies such as IBM and Union Carbide use this form of the mentoring process, which is proving to be very effective.

A fourth strategy is to maintain ongoing communications with expatriate managers, ensuring that they are aware of what is happening in the home office. If they are scheduled to be home on leave for any extended period of time, the company works them into projects at headquarters. In this way they can maintain their visibility at headquarters and increase the likelihood that they are viewed as regular members of the management staff rather than as outsiders.

These strategies that help MNEs maintain a proactive approach in dealing with expatriate concern are becoming more widespread. The best-managed multinational firms tend to have (1) mentor programmes consisting of one-on-one pairing of an expatriate with a member of the home-office senior management staff, (2) a separate organisation unit with primary responsibility

for the specific needs of expatriates, and/or (3) maintenance of constant contacts between the home office and the expatriate.

Active learning check

Review your answer to Active Learning Case question 2 and make any changes you like. Then compare your answer to the one below.

2 On what basis does Coca-Cola choose people for international assignments? Identify and describe two.

One of the bases on which Coca-Cola chooses people is the ability to speak at least two languages fluently. A second is familiarity with at least two cultures. Both are viewed as critical for success in international assignments.

TRAINING AND DEVELOPMENT

Training is the process of altering employee behaviours and attitudes in a way that increases the probability of goal attainment. **Managerial development** is the process by which managers obtain the necessary skills, experiences and attitudes they need to become or remain successful leaders. Training programmes are designed to provide those who are going overseas with information and experience related to local customs, cultures and work habits, thus helping them interact and work more effectively with local employees. Development is typically used to help managers improve their leadership skills, stay up to date on the latest management developments, increase their overall effectiveness and maintain high job satisfaction.

Types of training

MNEs use several types of training and development programmes. These can be grouped into two general categories: standardised and tailor-made.

Standardised training programmes are generic and can be used with managers anywhere in the world. Examples include programmes for improving quantitative analysis or technical skills that can be used universally. Research reveals that many behaviourally oriented concepts can also be handled with a standardised programme (although follow-up programmes must be tailor-made to meet specific country needs). Examples include programmes designed to acquaint participants with the fundamentals of communicating with, motivating or leading people. Another form of standardised training presently offered by large MNEs addresses cultural differences on a global scale. For instance, with operations in 200 countries, managers of Colgate-Palmolive are often exposed to more than one foreign

culture. To address this, the company has offered cultural diversity training to its managers.

Tailor-made training programmes are designed to meet the specific needs of participants and typically include a large amount of culturally based input. These programmes are more commonly developed by large MNEs and by multinationals that need a working knowledge of the local country's beliefs, norms, attitudes and work values. Quite often the input for the programmes is provided by managers who are currently working in the country (or have recently worked there) and by local managers and personnel who are citizens of that country. In most cases this training is provided to expatriates before they leave for their assignment, but in some cases it is provided on site.

Research shows that the following six types of programmes are most popular:

1. Environmental briefings used to provide information about such things as geography, climate, housing and schools.
2. Cultural orientation designed to familiarise the participants with cultural institutions and value systems of the host country.
3. Cultural assimilators using programmed learning approaches designed to provide the participants with intercultural encounters.
4. Language training.
5. Sensitivity training designed to develop attitudinal flexibility.
6. Field experience, which sends the participant to the country of assignment to undergo some of the emotional stress of living and working with people from a different culture.

Typically, MNEs use a combination of the above programmes, tailoring the package to fit their specific needs. A good example is provided by Underwriters Laboratories Inc., which uses a two-day, in-house programme to

train those personnel who will be dealing extensively with Japanese clients in the United States. The programme is designed around a series of mini-lectures that cover a wide range of topics, from how to handle introductions to the proper way of exchanging gifts. It employs a variety of training techniques, including lectures, case studies, role-playing, language practice and a short test on cultural terminology. The two-day training wraps up with a 90-minute question-and-answer period during which participants are given the opportunity to gain additional insights into how to develop effective client relationships.

Some firms extend their training focus to include families. In addition to providing language training, firms such as General Electric Medical Systems (GEMS) Group, a Milwaukee-based firm with expatriates in France, Japan and Singapore, match up the family that is going overseas with another family that has been assigned to this country or geographic region. The latter family will then share many of the problems it faced during the overseas assignment and relate some of the ways these situations were resolved. It is also common to find MNEs offering cultural training to all family members, not just to the manager. This helps create a support group that will work together to deal with problems that arise during the overseas assignment.

INTERNATIONAL BUSINESS STRATEGY IN ACTION

The glass ceiling

The glass ceiling has been a hot topic ever since the term was coined almost three decades ago and the sometimes-controversial debate over its existence and possible solutions shows no signs of cooling down. The term, which was first seen in the *Wall Street Journal* in 1986, has come to collectively symbolise the range of barriers which may be faced by women attempting to make their way up the promotions ladder to higher management levels in the corporate world.

As of 2018, 24 per cent of senior roles in global firms were occupied by women, yet a quarter of such businesses have no senior female representation at all, an issue that is most pronounced in mining, manufacturing and business services industries. In the UK, 22 per cent of senior management positions are held by women, with no all-male boards remaining in FTSE 100 listed companies. However, with UK female employment reaching 71.4 per cent in 2018, the highest since records began, and lagging only 9 per cent behind the male employment rate, it raises the question of why men continue to disproportionally advance through the organisational ranks. Several factors appear to be at work.

Women are normally the principal caregivers for children or other dependents within the family unit and this can lead to a range of potential explanations. First, women appear to undertake a process of self-selection, whereby they actively opt out of particular types of roles, such as those which cannot be easily combined with family responsibilities. According to a study by the ILM, 66 per cent of women cited predictable working hours as being important to them, and as a result, women may typically opt for part-time roles or those which may allow for breaks in employment, or choose to remain in a more junior role, thus accounting for the imbalance in gender at more senior levels.

For women who don't opt out, work–life balance challenges can prove to be quite an obstacle to progression. Working hours can be intense and erratic, particularly in professional service sectors like law, accountancy and management consulting. Many top-level positions also require the individual to travel, and having a level of mobility and flexibility is a key to advancement in many firms.

In response to the problem of the glass ceiling and gender disparity, many firms have looked to develop their maternity leave arrangements and flexible working opportunities, and advances in technology now allow the option of working from home. Leading by example also plays a very important role, with 41 per cent of women surveyed by the ILM citing the lack of female role models as a barrier to progression. Furthermore, it was highlighted that there was a lack of role models (and therefore a lack of individuals?) who manage to successfully combine a career and family life, rather than they are typically women who have made sacrifices in this area to reach their senior position.

Perhaps most important of all, however, is raising awareness of the glass ceiling in men. In the banking sector, for example, only one-fifth of men acknowledge its existence. This is a major barrier to progressing gender equality and arguably acts as a limitation on firm performance. According to a study by McKinsey & Company, those firms which have the greatest number of women on their senior teams reported increased operational results, growth in equity and a rise in share price. Furthermore, based on nine different criteria for organisational excellence, those firms in which women account for a third of the senior team perform better than those with no women at senior level. Having more women in senior positions therefore undoubtedly has a positive impact on company performance.

According to the *Harvard Business Review*, research has also shown that, although women tend to receive mentoring, they rarely have a sponsor to help them progress. In fact, males are 46 per cent more likely to have a sponsor and, in turn, receive clear support and advice. PricewaterhouseCoopers (PwC), the UK's largest professional service firm offering assurance, advisory and tax services, has taken steps to change this. In order to aid some of the organisation's most talented females in achieving their full potential, in 2010 PwC launched its Female Board Mentoring Sponsorship programme involving 26 employees, with 7 more joining since then. They were matched with senior male executives who in turn introduced them to their networks and worked with them on high-profile projects. Impressively, 60 per cent of the women were selected for leadership roles and 90 per cent had been promoted in the first three years of the programme. PwC was awarded the 'Opportunity Now Advancing Women in the Workplace' award in 2013 in recognition of its efforts.

If we look at the phenomenon internationally, there is a stark disparity between different countries. The glass-ceiling index (Figure 13.2) ranks the environment for working women in 29 nations based upon factors including average educational attainment, the cost of childcare, parental rights, labour market attachment and female representation in senior positions (e.g. on company boards).

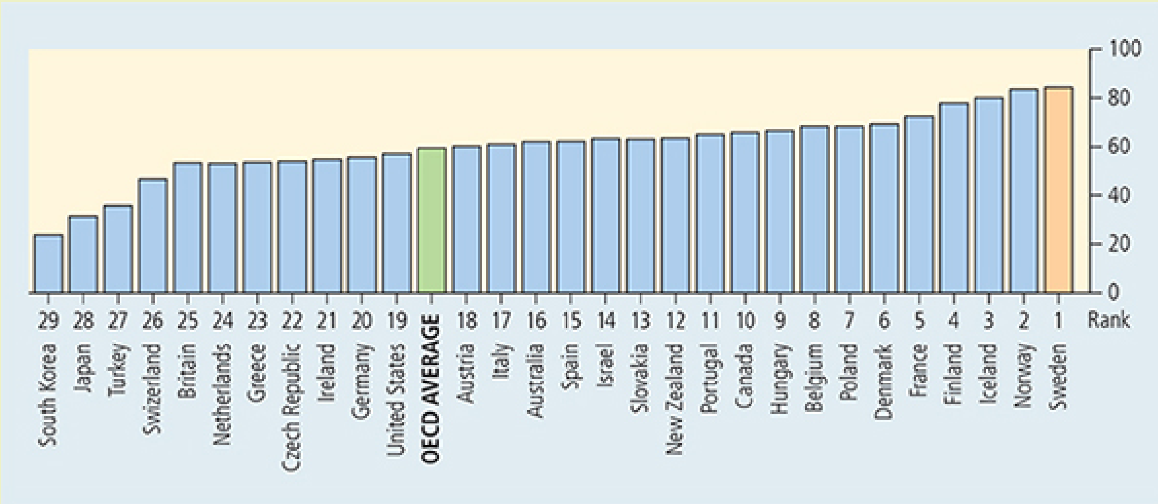

Figure 13.2 Glass-ceiling index, 2017

Sources: European Institute for Gender Equality; Eurostat; GMAC; ILO; Inter-Parliamentary Union; OECD; national soures; *The Economist.*

Perhaps unsurprisingly (as they are also renowned for their high quality of life), the Nordic countries Sweden, Norway, Iceland and Finland took the four tops spots in 2017, with Denmark coming in behind France in sixth position. The US and UK ranked nineteenth and twenty-fifth respectively, both scoring below the OECD average, while South Korea was ranked as having the worst environment for working women in the sample. South Korea's score is influenced by its high gender pay gap with women earning 36 per cent less than men and a having a relatively low labour force participation, despite extremely low childcare costs which are only marginally more expensive than index leader Sweden's.

While, on average the situation is improving, there is still a way to go. The recent #MeToo movement highlighted some of the issues facing women in the workplace and contributed to

increasing sentiments of female empowerment, but tangible actions from employers, with policy interventions from governments where necessary, are needed to break the glass ceiling.

Countries at the bottom of our index show signs of change in their cultural attitudes. Last year the Global Summit of Women, a business and economic gathering of over 1,300 leaders from 60-odd countries, was held in Japan for the first time. The #MeToo movement, a social-media campaign against sexual assault and harassment, arrived in South Korea with fervour. Allegations of inappropriate behaviour against senior prosecutors, chaebol owners and board members in the country have since come to light as more women are feeling empowered.

Websites: https://www.economist.com/graphic-detail/2018/02/15/the-glass-ceiling-index; https://www.catalyst.org/research/women-in-management/; http://researchbriefings.files.parliament.uk/documents/SN06838/SN06838.pdf

Sources: Elizabeth Antoniou, 'Glass ceiling – thing of the past?', *Performance Psychology*, OPM Consulting; Claire Cohen, 'Women can be CEOs and mothers. But Marissa Mayer's maternity leave is a bum idea', *Telegraph*, 5 September 2015; Institute of Leadership & Management, 'Women in banking', accessed from https://www.i-l-m.com/~/media/ILM%20Website/Downloads/Insight/Reports_from_ILM_website/Research_womeninbanking_march12%20pdf.ashx; Helen Briggs, 'ONS: mothers' average age hits 30', *BBC News*, 16 July 2014; Emma Jacobs, 'Sponsors crack glass ceilings', *Financial Times*, 8 July 2013; Rachel Savage, 'Female managers aren't 'working for free' – but they are missing out on promotions', *Management Today*, 25 August 2015; PwC, 'PwC – champion of gender equality', accessed from http://workplace.bitc.org.uk/ChampionPwC; Emily Stewart, 'The diamond ceiling: women CEOs aren't hauling in gaudy pay packages like male peers', *The Street*, 27 August 2015; Equality and Human Rights Commission, *Employment and Earnings in the Finance Sector: A Gender Analysis*, 2009; McKinsey & Co., *Women Matter: Gender Diversity, A Corporate Performance Driver*, 2007; Sylvia Ann Hewlett, with Kerrie Peraino, Laura Sherbin, and Karen Sumberg, *The Sponsor Effect: Breaking through the Last Glass Ceiling*, December 2010, accessed from http://30percentclub.org/wp-content/uploads/2014/08/The-Sponsor-Effect.pdf.

Active learning check

Review your answer to Active Learning Case question 3 and make any changes you like. Then compare your answer to the one below.

3 **What type of training does Coca-Cola provide to its interns? Of what value is this training?**

The company puts interns into groups and assigns projects that require them to investigate or study certain areas of operations. The interns are then evaluated on the outcome. This training is useful in helping the firm identify those individuals who offer the most promise for the company.

COMPENSATION

In recent years compensation has become a primary area of IHRM attention. On the one hand, multinationals want to hire the most competent people. On the other hand, they want to control costs and increase profits. Sometimes these two objectives are not compatible; it can be expensive to relocate an executive overseas. A close look at the breakdown of international compensation packages helps to make this clear.

Common elements in an international compensation package

A typical international compensation package includes base salary, benefits and allowances. In addition, most packages address the issue of tax protection and/or tax equalisation. The following examines these four elements.

Base salary

Base salary is the amount of cash compensation an individual receives in the home country. This salary is typically the benchmark against which bonuses and benefits are calculated. Survey research reveals that the salaries of expatriates are tied to their home country, so a German manager working for a US MNE and assigned to Spain will have a base salary tied to the salary structure in Germany.[7] This salary is usually paid in the home currency, the local currency or a combination of the two.

Salary has become an issue when foreign firms have merged or acquired companies in other countries where salaries are significantly higher. Moreover, international differences in salaries also create difficulties, as discussed below.

Benefits

Benefits often make up a large portion of the compensation package. There are also a number of difficult issues that typically must be resolved, including how to handle medical coverage, what to do about social security and how to handle the retirement package. Some of the specific issues that receive a great deal of attention are:

- whether or not to maintain expatriates in home-country programmes, particularly if the company does not receive a tax deduction for it;
- whether companies have the option of enrolling expatriates in host-country benefit programmes and/or making up any difference in coverage;
- whether host-country legislation on termination affects benefit entitlements;
- whether expatriates should receive home-country or host-country social security benefits; and
- whether benefits should be maintained on a home-country or host-country basis, who is responsible for the cost, whether other benefits should be used to offset any shortfall in coverage and whether home-country benefit programmes should be exported to local nationals in foreign countries.

Most US MNEs include their expatriate managers in the company's benefit programme and the cost is no more than it would be back home. In cases in which a foreign government also requires contribution to a social security programme, the company picks up this expense for the employee. Fortunately, in recent years a number of international agreements have been signed that eliminate requirements for dual coverage.

MNEs also provide vacations and special leave to expatriates. This often includes company-paid air fare back home for the manager and family on an

annual basis, as well as emergency leave and expense payments in case of death or illness in the family.

Allowances

Allowances are another major portion of some expatriate compensation packages. One of the most common is the **cost-of-living allowance**, which is a payment to compensate for differences in expenditures between the home country and the foreign location. Designed to provide employees with the same standard of living they enjoyed in the home country, this allowance can cover a wide variety of areas, including relocation, housing, education and hardship.

Relocation expenses usually include moving, shipping and storage charges associated with personal goods that the expatriate is taking overseas. Related expenses can include pre-requisites such as cars and club memberships, which are commonly provided to senior-level managers. Housing allowances are used by some MNEs, either through a monthly payment or the use of company housing owned by the firm. Education allowances for an expatriate's children are also sometimes paid, but these are less common than they used to be.

A **hardship allowance** is a special payment made to individuals who are posted to areas regarded as less desirable. For example, parts of Europe, China and some Middle East countries typically receive a hardship premium as an inducement to accept the assignment. These payments can be in the form of a lump sum ($10,000 to $25,000) or a percentage (15 to 50 per cent) of the individual's base compensation.

Taxation

MNEs provide tax protection and/or tax equalisation for expatriates. For example, a US manager sent abroad can end up with two tax bills: one for

income earned overseas and the other for US taxes on these monies. Section 911 of the US Internal Revenue System code permits a deduction of up to $70,000 on foreign-earned income. For some executives, however, some US taxes might still be due. In handling these situations, most MNEs have a tax equalisation programme under which they withhold an amount equal to the home-country tax obligation of the manager and then pay all taxes in the host country. With tax protection, the employee pays up to the amount of taxes equal to those he or she would pay based on compensation in the home country. In this case, the employee is entitled to any difference if total taxes are less in the foreign country than in the home country. Other MNE tax considerations involve state and local tax payments and tax return preparation.

The most common approach is for the MNE to determine the base salary and other extras (bonuses etc.) the manager would make while living in the home country. The taxes on this income are then computed and compared to the total due on the expatriate's income, and the multinational pays any taxes over and above the amount that would have been due in the home country.

Compensation trends and comparisons

In terms of compensation, the MNE's objective is to ensure that expatriates do not have to pay any additional expenses as a result of living abroad. Figure 13.3 illustrates this idea, but also shows significant differences across Asia-Pacific countries for expatriate packages made up of salary, tax and benefits.

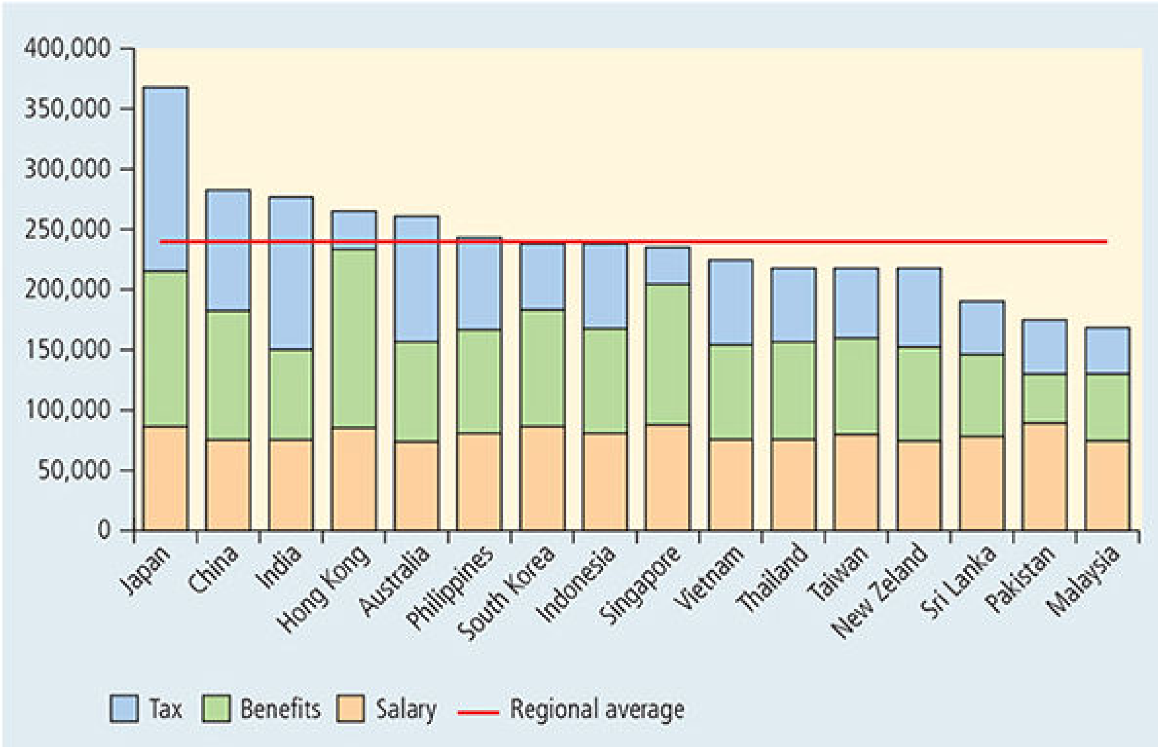

Figure 13.3 Expatriate packages for middle managers: Asia-Pacific countries compared (US$)

Source: https://www.eca-international.com/news/may-2017/expatriate-pay-packages-in-taiwan.

Table 13.1 Ratio between CEO and average worker pay, 2016

Country	Ratio
South Africa	541.40
India	483.06
US	298.98
UK	228.70
Canada	202.98
Switzerland	179.34
Germany	175.65
Spain	172.42
Netherlands	172.32
Israel	119.42

Source: Bloomberg (2018). https://qz.com/africa/841172/the-bloomberg-ranking-ofceo-salaries-shows-that-south-african-executives-earn-the-most-relative-to-theaverage-income/.

Because the overall package can be substantial, there is a trend towards not sending expatriates to overseas positions unless there is a need for their specific services. In fact, the costs have become so prohibitive that firms like Dow Jones & Company, owner of the *Wall Street Journal*, long ago radically revised its formula for paying allowances for housing, goods and services. In addition, MNEs are increasingly replacing permanent relocation and long-term assignments with as-needed short trips that typically last less than a year.

When we step back and compare salaries across countries, we get an insight into some of the difficulties maintaining parity or equality across groups of managers doing basically the same job but in different places. The starkest contrasts appear when we compare CEO salaries around the world. The United States stands out in terms of the average remuneration for CEOs compared to any other industrialised nation. It also stands out as the leading developed country in terms of the difference between top executive salaries and those of the average worker (Table 13.1). But India and South Africa show far higher disparities between the top-paid executives and the rest, and we would expect similar patterns in other developing and emerging economies.

This ratio difference between the CEO and average workers attracts strong criticism from governments and public interest groups across many countries. These disparities may also be underestimated because of the other areas of compensation, including stocks and shares, bonuses, housing and travel allowances which are not included in the table. There is also evidence that shows that the top 1–5 per cent are receiving a greater proportion of the salary pie and the bottom 20–30 per cent are getting less, across a large number of developed countries. The variation across national systems also seems to be symbolic of broader socio-economic and cultural differences between these countries.[8] Differences in corporate governance systems, the role of financial

incentives, and, more fundamentally, differences in the role of corporations in society are reflected in these data.

LABOUR RELATIONS

One of the major challenges facing MNEs is that of orienting their strategy to meet the varying demands of organised labour around the world (see Figure 13.4). National differences in economic, political and legal systems create a variety of labour relations systems, and the strategy that is effective in one country or region can be of little value in another country. Figure 13.4 shows the significant variation in trade union membership across different countries.

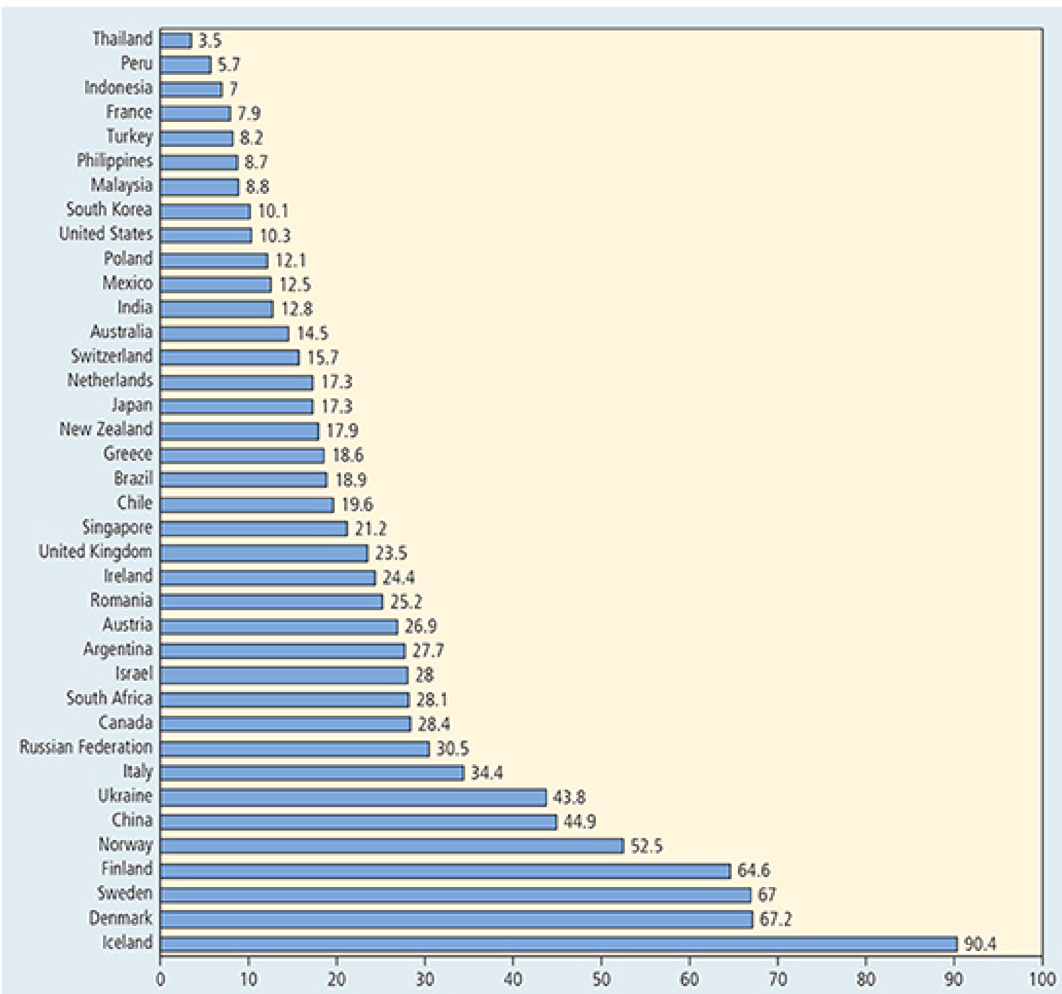

Figure 13.4 **Trade union density, 2016**

Website: http://www.ilo.org/ilostat/faces/oracle/webcenter/portalapp/pagehierarchy/Page3.jspx?MBI_ID=9

Source: International Labour Organization. ILOSTAT. Downloaded April 2019.

In managing labour relations, most MNEs use a combination of centralisation and decentralisation, with some decisions being made at headquarters and others being handled by managers on site. Researchers have found that US MNEs tend to exercise more centralised control than European MNEs. A number of factors have been cited to explain this development; for example, US companies tend to rely heavily on formal management controls and a close reporting system is needed to support this process. Also, for many US firms the domestic market represents the bulk of their sales (a situation that is not true for many European MNEs) and the overseas market is managed as an extension of domestic operations.

Labour relations practices

Labour relations practices vary widely. In some countries, the economy is strong and unions are able to make major demands; in other countries the economy is weak and the unions' ability to bargain is diminished. Similarly, some countries have strong pro-management governments whereas others are heavily union oriented. A third factor is the willingness of unions to strike or walk out as opposed to continuing to talk with management in the hope of resolving differences. Germany and Japan provide some interesting contrasts. Across the industrialised world membership and power of trade unions has been declining and many associated this trend with the growing wage inequalities described above.

Germany

Labour unions traditionally have been strong in Germany. Although a minority of the labour force is organised, unions set the pay scale for a large proportion of the country's workers, with wages determined by job classifications. Union membership is voluntary, but there is only one union in each major industry. This union negotiates a contract with the employers' federation for the industry, and the contract covers all major issues, including wages and terms of employment. If there is a disagreement over the interpretation or enforcement of the contract, the impasse is typically resolved between the company and the worker with the participation of a union representative or work council. If this procedure is unsuccessful, the matter can then be referred to a German labour court for final settlement. Despite their power, unions have a much more cooperative relationship with management than do their counterparts in the United States. One reason is that workers serve on the board of directors and can ensure that the rank and file are treated fairly.

Japan

In Japan, union–management relationships are extremely cooperative. Social custom dictates non-confrontational behaviour. So, although labour agreements are often general and vague, disputes over interpretations tend to be settled amicably. Sometimes it is necessary to bring in third-party mediators or arbitrators, but there are no prolonged, acrimonious disputes that end up in a plant being closed down because the two sides cannot work together. Typically, a strike is used merely to embarrass the management and seldom lasts longer than one week. Although it is possible to resort to legal action in resolving strikes, this is typically frowned upon by both labour and management, and both sides try to stay away from using this means of bringing about solutions to their problems.

Japanese unions are most active during the spring and at the end of the year, the two periods during which bonuses are negotiated. However, these activities do not usually end up in a union–management conflict. In overall terms, Japanese workers tend to subordinate their interests and identities to those of the group. This cultural value helps account for a great deal of the harmony that exists between labour and management (see Chapter 17).

INTERNATIONAL BUSINESS STRATEGY IN ACTION

Primark: putting global stakeholders first

Established in 1969, Primark is a subsidiary company of Associated British Foods (ABF) and is currently one of the largest clothing retailers in Europe. In 2018, Primark had 360 stores which employed 75,000 people in the UK, Republic of Ireland, Spain, Portugal, Germany, the Netherlands, Belgium, Austria, France, Italy and the US. Primark's competitive success is based on providing fashionable goods at the lowest possible price. With this unique strategic combination, Primark has continually been able to increase its range, covering womenswear, menswear, children's wear, footwear, lingerie, accessories and homeware. In order to provide goods at the lowest possible price, Primark sources the majority of its products from developing countries such as China, Bangladesh, India and Vietnam.

In 2017, Primark's total revenue was approximately $9,680 million with a profit margin of 11.3 per cent. Primark doesn't show signs of slowing down and in 2019 it opened its largest store, measuring at 160,000 sq ft, in Birmingham (UK). As part of the ABF Group, Primark shares important ethical values in relation to its employees and wider stakeholders. These broadly include taking care of their people, being a good neighbour, respecting human rights and engaging with stakeholder organisations. This case study looks at the different ways in which Primark engages with key external stakeholders. Figure 13.5 highlights a selected range of these stakeholder groups.

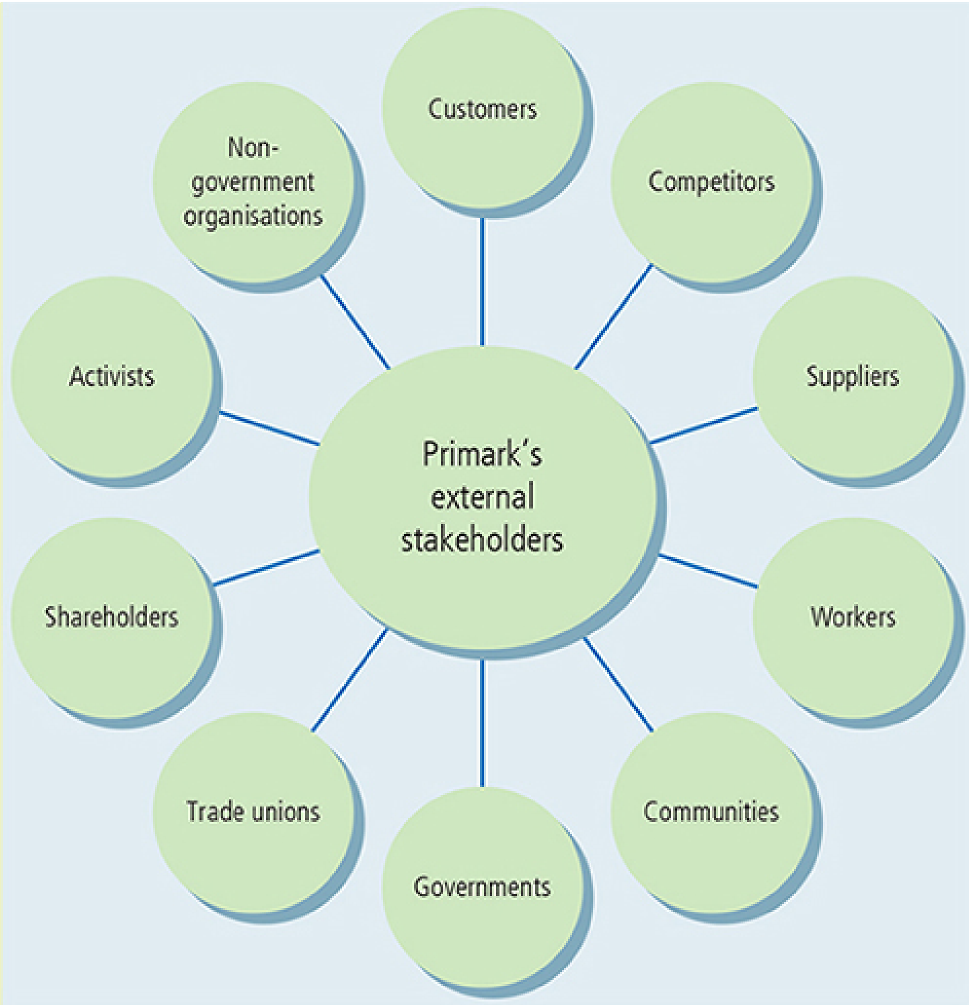

Figure 13.5 **Primark's key stakeholders**

Primark incorporates a range of techniques in order to effectively engage with different stakeholder groups. For instance, when looking to engage with workers and communities within a given country, Primark uses the model of the community engagement programme which it first used in India. However, one key lesson from Primark's experience in India was the importance of understanding the needs of specific groups of stakeholders in different countries and adapting its approach accordingly.

Trade unions and civil society groups

With the aim of protecting workers, Primark has been working closely with a range of global civil society groups and trade unions. The firm successfully engages with these groups by listening and

learning about their concerns, often with the partnership of multiple stakeholders. They then jointly develop ways to overcome these issues. Two key organisations which assist Primark with this approach are the Ethical Trading Initiative (ETI) and the International Labour Organization's Better Work Programme. The ETI is an alliance of organisations, trade unions and other voluntary organisations that simultaneously work together in order to improve the lives of workers who produce their goods. Primark has been a member of the ETI since 2008 and was awarded 'Leader' status by the ETI in 2011 and 2012. The 'Leader' status is the highest possible status and demonstrates continuous and robust improvements in auditing and training programmes and substantial engagement with external stakeholders. In 2014, the ETI decided to adjust its standards concerning working hours, which provided clarity in the maximum number of hours that workers should be asked to work in a week. Given this, Primark were quick to adjust their working code and informed their suppliers of this change. Moreover, in 2018, Primark, produced a free curriculum-based teaching resources for UK secondary schools that was made publically accessible via their 'Our Ethics' online webpage.

In 2010, Primark became a member of the Better Work Programme, which is a global partnership initiated by the UN's International Labour Organization to improve global labour practices. Being part of this programme involves regular factory assessments, which seek to ensure adherence to international standards. Primark believes that collaboration with key external stakeholders helps generate innovation and sustainability in the global garment manufacturing industry as well as promoting fairness through improved wealth distribution.

Workers and communities

Primark primarily sources its products from garment world leaders such as China, Bangladesh, India and Vietnam. As workers from these countries have often been recognised as being the most vulnerable within the supply chain, successful engagement within these communities is a critical component of Primark's ethical approach. Primark often works with local non-government organisations (NGOs), which have the local knowledge to support Primark's initiatives. A series of joint programmes with NGOs demonstrates its commitment.

For instance, in Bangladesh, 16 factories which Primark continually buys from have been working closely with Nari Uddug Kendra (NUK), an NGO that focuses on women's rights. Working with NUK, Primark has introduced training schemes in factories with the aim of managing workers more fairly and educating them as to their rights. One report suggests that over 1,000 workers have been involved with this scheme. Since 2011, in Bangladesh, Primark has also introduced the HER project, which has provided thousands of women workers with support in education, hygiene, sexual and reproductive health issues. The HER project has led to an increase in the number of women now being able to access appropriate health clinics (by 89 per cent) and contraception services (by 55 per cent). Overall, just over 10 years from its inception in 2007, the HER project has worked with over 750 workplaces across 14 countries and has positively impacted the lives of more than 850,000 women.

Furthermore, in China and Bangladesh, Primark has introduced projects with the aim of developing long-term improvements in labour standards and providing workers with living wages. In southern India, Primark has been working closely with another NGO to identify workers and families who may be at risk in regard to certain issues via the use of surveys, which guide initiation of education, hygiene and gender projects in the region. Since 2011, Primark has also teamed up with Business for Social Responsibility (BSR), a corporate social responsibility organisation with over 250 members, in order to identify labour migration trends within China.

Customers

Primark's competitive strength revolves around providing consumers with the latest fashionable goods at the lowest possible price. However, Primark does not have a significant advertising and marketing budget, as its strategy is to get consumers themselves to spread the word about its products. Even though Primark aims to provide consumers with products at the lowest possible price, it also actively seeks to ensure that it is complying with ethical guidelines. This is demonstrated on its ethical trading website, which provides Primark with a platform when communicating with its customers. Furthermore, Primark has been engaging with its customers via The School Project. The School Project aims to bring awareness among young people surrounding the topic of ethical trading. An example of how Primark tells its customer can be seen on their

website, which shows customers exactly where Primark's products are sourced around the world. Moreover, in 2018 their website also illustrates exactly how many people work within the factories, as well as the proportion of men and women working within these factories.

Shareholders

As Primark's shareholders own the company, they ultimately have the power when making key decisions. For instance, shareholders are able to suggest and select individuals among the board members. Shareholders expect Primark to adopt ethical business practices among all its stakeholders. ABF issues a separate corporate social responsibility (CSR) report to its shareholders, which demonstrates the ways in which Primark has been acting upon its ethical and social responsibilities.

Conclusion

Primark is a successful clothing retailer in Europe which provides consumers with the latest fashionable goods at the lowest possible prices. Promising consumers low-priced products has often attracted negative media attention for the firm over the pay rates and conditions of its workers in developing-country factories. A closer look at the company's practices reveals that Primark acknowledges these concerns and is working closely with retailers, other brands, industry bodies, trade organisations, advocacy groups, NGOs, suppliers, workers and communities to ensure their concerns are heard. Primark thoroughly believes that working together with stakeholders as a team can ensure all issues are appropriately raised and successfully addressed.

Sources: ABF, *Annual Report*, 2014, 2018; 'Working with stakeholders', accessed from http://www.abf.co.uk/responsibility/our-actions/working_with_stakeholders_primark; Primark Ethical Trading, 'Our work in Bangladesh', accessed from http://www.primark-bangladesh.com/our-work-in-bangladesh/; 'Primark ethical trade team', accessed from http://www.abf.co.uk/responsibility/our-actions/primark_ethical_trade_team; https://www.primark.com/en/our-ethics; https://www.ethicaltrade.org/blog/primarks-new-teaching-resources-explore-its-international-supply-chain; https://www.primark.com/en/our-ethics/people-production/standards-in-factories; https://herproject.org/.

Industrial democracy

Unlike the United States, many countries have **industrial democracy**, which is the legally mandated right of employees to participate in significant management decisions. This authority extends into areas such as wages, bonuses, profit sharing, work rules, dismissals and plant expansions and closings. Industrial democracy can take a number of different forms.

Forms of industrial democracy

At present, there are a number of forms of industrial democracy. In some countries one form may be more prevalent than others, and it is common to find some of these forms existing simultaneously. The following describes three of the most popular forms.

Codetermination

Codetermination is a legal system that requires workers and their managers to discuss major strategic decisions before companies implement them. It has brought about worker participation on boards of directors and is quite popular in Europe, where Austria, Denmark, the Netherlands and Sweden have legally mandated codetermination. In many cases the workers hold one-third of the seats on the board, although it is 50 per cent in private German companies with 2,000 or more employees. On the negative side, some researchers report that many workers are unimpressed with codetermination and feel that it does not provide sufficient worker input to major decisions.

Work councils

Work councils are groups that consist of both worker and manager representatives and are charged with dealing with such matters as improving company performance, working conditions and job security. In some firms these councils are worker or union run, whereas in others a management

representative chairs the group. The councils are a result of either national legislation or collective bargaining at the company–union level, and they exist throughout Europe. However, their power varies. In Germany, the Netherlands and Italy, work councils are more powerful than they are in the UK, France and Scandinavia.

Shop floor participation

Shop floor participation takes many forms, including job enrichment programmes, quality circles and various other versions of participative management. These approaches give workers an opportunity to make their voices heard and play a role in identifying and resolving problems. Shop floor participation is widely used in Scandinavian countries and has spread to other European nations and the United States over the last two decades.

STRATEGIC MANAGEMENT AND IHRM STRATEGIES

A number of HRM strategies are currently receiving attention from MNEs. Four that do warrant consideration are language training, cultural adaptation, competitive compensation and specially designed HRM programmes.

Language training

English is the primary language of international business. However, training in the host-country language can be particularly useful because it allows managers to interact more effectively with their local colleagues and workers, and communicate more directly with suppliers and customers. Another advantage is that the training allows the manager to monitor the competition more effectively. Language training is also useful for recruiting local talent and developing good relations with local organisations.

By learning the local language, managers also learn a great deal about a country's culture, norms and business practices and how to interact socially with local people. Research reports that most US expatriate managers give little importance to the value of a second language. In contrast, executives from South America, Europe and Japan place a high priority on speaking more than one language.

Active learning check

Review your answer to Active Learning Case question 4 and make any changes you like. Then compare your answer to the one below.

4 How useful is it for Coca-Cola's managers to be fluent in more than one language? Why?

Coca-Cola's managers must be fluent in other languages because the company believes this allows them to operate effectively in at least two different cultures. This permits the company to transfer managers from one geographic region to another and to know that the managers will be able to become acculturated within a minimum time period. Moreover, because there are common languages in many regions of the world, a manager who is fluent, say, in English and Spanish could be transferred to countries throughout North America, South America, Europe, Africa and Australia. Thus, bilingualism provides the company with a cadre of managers who can literally span the globe.

Cultural adaptation

Closely tied to language training is the need for managers to understand the culture of the country to which they are assigned. The importance of culture was discussed in Chapter 5, where it was noted that major differences exist between cultural clusters. In preparing managers for overseas positions, MNEs are now using three basic approaches. The simplest and least expensive is to design a programme that provides cultural orientation by familiarising individuals with the country's cultural institutions and value systems. This is often done through a formal training programme and/or meetings with company personnel who have just returned from a posting in that country. The second is to provide individuals with language training and, if time and money permit, allow them to visit the country. Some MNEs tie this approach to a manager's assignment by setting aside the first couple of

weeks on site for orientation and acculturation. A third approach that is fairly expensive but has received high marks for its value is the use of cultural assimilators.

Cultural assimilators

A **cultural assimilator** is a programmed learning technique designed to expose members of one culture to some of the basic concepts, attitudes, role perceptions, customs and values of another. Cultural assimilators are developed for pairs of cultures, such as familiarising managers from the United States with the culture in Germany. Of course, an assimilator can be developed for expatriates who are assigned to any culture in the world, and the approach almost always takes the same format: the person being trained is asked to read a short episode of a cultural encounter and then choose an interpretation of what has happened and why. If the response is correct, the individual goes on to the next episode. If not, he or she is asked to reread the episode and then make another choice.

Cultural assimilators use critical incidents as the basis for training. These incidents are typically ones in which (1) the expatriate will be interacting with a host nation, (2) the situation may be misinterpreted or mishandled if the expatriate is not properly trained, and (3) the event is relevant to the expatriate's task or mission requirements. The incidents are provided by expatriates who have served in this particular country, as well as by members of the host nation.

Assimilators can be expensive to create, but for larger MNEs this tool and the associated training is often worth the investment. Although it is difficult to ascribe specific costs to culture clashes, miscommunication and misunderstanding, managers who have experience of working in different countries know that firms can lose a large proportion of their investments because of a lack of training and preparation for key expatriate workers.

Competitive compensation

MNEs are also beginning to evaluate more carefully the cost of sending people overseas as well as to review the expense of maintaining executive talent in the international arena. The first of these concerns focuses on all expatriates. The second addresses top-level managers only.

Compensation costs vary widely because goods and services in some countries are sharply higher (or lower) than in others. Table 13.2 provides an overall comparison of the costs of living in major global cities, benchmarked against New York. The cost-of-living allowance for overseas managers in Europe and Japan, for example, adds significantly to the MNE's overhead. For this reason, all MNEs look for ways to recruit and develop local talent to staff operations and thus reduce their reliance on expatriates.

The other major area of compensation that is receiving increased attention is hiring and retaining top management talent. Research shows that the cost of hiring senior-level managers is extremely high, and in most cases these individuals received a substantial salary raise when they moved into their new position. Moreover, as the demand for talented executives rises, the salaries of international managers will continue to rise. This is one reason why many MNEs are now hiring people for specific locations and leaving them in place for extended periods of time. This strategy is less costly than continually moving managers from one geographic location to another.

Table 13.2 Cost of living in select cities (New York = 100), 2017

	Location	Cost of living, including rent, relative to New York		Location	Cost of living, including rent, relative to New York
1	Zurich	104.3	26	Frankfurt	73.3
2	Geneva	102.9	27	Vienna	72.8
3	New York*	100.0	28	Dubai	72.8
4	Oslo	96.9	29	Taipei	72.7
5	Copenhagen	94.4	30	Rome	72.0
6	Tokyo	89.7	31	Toronto	71.6
7	Paris	88.0	32	Berlin	69.8
8	London	87.6	33	Lyon	68.7
9	Chicago	86.7	34	Montreal	68.6
10	Milan	86.1	35	Madrid	66.9
11	Luxembourg	84.2	36	Barcelona	64.1
12	Sydney	84.1	37	Doha	64.0
13	Helsinki	84.1	38	Athens	64.0
14	Hong Kong	81.5	39	Zagreb	63.7
15	Dublin	81.3	40	Panama	63.1
16	Stockholm	79.8	41	Lisbon	62.4
17	Los Angeles	79.7	42	Nicosia	62.1
18	Auckland	78.9	43	Ljubljana	60.6
19	Seoul	77.4	44	Tallinn	60.2
20	Tel Aviv	77.0	45	Beijing	60.1
21	Brussels	76.8	46	Bratislava	57.8
22	Munich	75.9	47	Moscow	57.3
23	Miami	75.3	48	Shanghai	56.8
24	Amsterdam	74.5	49	Buenos Aires	56.7
25	Panama City	73.7	50	Johannesburg	55.7

Source: Data Explorer, UBS Retrieved from https://www.ubs.com/microsites/prices-earnings/en/explore/?split=false.

Specially designed HRM programmes

In recent years, a growing number of MNEs have begun to realise that HRM practices have to be tailor-made, either through investment in the in-house HR function and/or through hiring external consultants. In addition to the general problem of recruiting and retaining talent, a number of other factors have driven this trend, including:

- Structural changes to MNEs, including flatter organisations, wider spans of managerial control, greater use of flexible cross-functional teams.
- More performance-based pay and the rewarding of individuals for productivity gains.
- More investment in continuous training and development education and the rewarding of personnel for enhancing their skills and knowledge.

- Better provision for employee welfare (in some firms), including firms offering personal family assistance, encouraging and often organising external volunteer activities, citizenship and local community engagement.
- More equality and diversity in the workplace, although again, this varies a great deal by firm and location.

This creates additional dilemmas for MNEs, given that different approaches have to be developed for different. What works well in Kenya may have limited value in France or Dubai. This is even the case across Anglophone nations such as the United States, Canada, Australia and the UK, where differences in employee welfare emphasis, accelerated resource development, long efficiency orientation, and long-term vision show different HRM profiles for each. MNEs in the future will have to focus increasingly on HRM programmes designed to meet the needs of local personnel.

KEY POINTS

1 International human resource management (IHRM) is the process of selecting, training, developing and compensating personnel in overseas positions. IHRM strategies involve consideration of staffing, selecting, training, compensating and labour relations in the international environment.

2 A number of screening criteria are used in choosing people for international assignments. These include adaptability, self-reliance, age, experience, education, health, family status, motivation and leadership. The most common selection procedure is the interview, although some firms also use testing. In recent years MNEs have also begun formulating repatriation strategies for integrating returning managers back into the workplace at home.

3 Training and development programmes are another key part of IHRM strategies. There are a wide variety of these programmes, ranging from environmental briefings to language training.

4 There are a number of common parts in a typical international compensation package, including base salary, benefits, allowances, and tax protection and/or equalisation. In essence, the package's objective is to ensure that the expatriate does not have to pay any additional expenses as a result of living abroad.

5 Labour relations practices vary widely in the international arena. For example, union–management relations and industrial democracy approaches are different throughout Europe, and these differ dramatically from those in Japan.

6 A number of HRM strategies are currently receiving a great deal of attention from MNEs. Three of these are language training, cultural adaptation and competitive compensation.

Key terms

- **international human resource management (IHRM)**
- **home-country nationals**
- **expatriates**
- **host-country nationals**
- **third-country nationals**
- **international screening criteria**
- **repatriation**
- **transition strategies**
- **repatriation agreement**
- **training**
- **managerial development**
- **standardised training programmes**
- **tailor-made training programmes**
- **cost-of-living allowance**
- **hardship allowance**
- **industrial democracy**
- **codetermination**
- **work councils**

- **cultural assimilator**

REVIEW AND DISCUSSION QUESTIONS

1 Many US MNEs are accused of not focusing their efforts sufficiently on internationalisation. How can they develop an international perspective among their managers? Offer three suggestions.
2 What are some of the most common screening criteria for individuals being chosen for international assignments? Identify and discuss four of them.
3 Why do MNEs tend to prefer interviews to testing when selecting people for international assignments?
4 In what way is repatriation proving to be a major problem for MNEs? How can they deal with this issue? Offer two substantive recommendations.
5 What are some of the most common forms of training and development offered to people going international or already operating abroad? Identify and describe three of them.
6 What are the most important parts of an international compensation package? Identify and describe three of them.
7 Why do some compensation packages have a hardship allowance?
8 In terms of compensation, why do many MNEs prefer to use a local manager rather than bring in an expatriate?
9 What are some of the primary differences in labour relations practices between Germany and Japan? Identify and discuss two of them.
10 How does industrial democracy work? Compare and contrast its use in Denmark, Germany and Japan.
11 How are MNEs attempting to improve the language training given to their personnel being posted overseas?
12 How would an MNE use a cultural assimilator to prepare people for overseas assignments?
13 What are some of the latest trends in competitive compensation in the international arena? Identify and describe two of them.

REAL CASE

India’s role in the global offshoring economy

Moving operations and functions to overseas locations, known as offshoring, is a well-established restructuring practice, as evidenced by the relocation of many manufacturing activities from developed market economies to overseas locations, such as China. However, the offshoring of services is also notable; in fact, India’s IT sector exports totalled approximately $70 billion in 2018, up from $52 billion in 2015.

Political views on offshoring can be highly critical; President Trump’s election platform focused on bringing jobs back (‘reshoring’) to the US from their outsourced locations, while British trade unions have also campaigned to stop the practice of offshoring. Nevertheless, it remains a popular business practice, with firms including Goldman Sachs and Deutsche Bank offshoring service functions to India. In the mid-2000s, India’s high-tech sector was growing at 30 per cent per year and the volume of outsourcing contracts at 50 per cent per year. India has carved itself a reputation as the destination of choice for the delivery of business services, but growth in the IT sector and in call centre operations has been notable. Whereas in manufacturing industries capital investment in new technologies can reduce reliance on human capital, this is not currently possible to the same extent in services, which tend to require a human interface. As a result, labour is a significant operating cost in service industries, which firms can reduce through offshoring to cheaper labour locations.

However, India does have a number of factor conditions which make it a ripe destination for outsourcing. The colonial influence on India’s development has resulted in an institutional environment conducive to the relocation of British and American activities; it has a common law legal system due to prior colonial rule as well as English-language schooling. Furthermore, with a booming population, India has an abundant supply of competitively cheap labour, even for university-educated workers, allowing firms to decrease their operating costs.

Of course, technological developments are at the heart of offshoring decisions; the emergence of the internet is what enabled the separation of firm activities across borders, and now further technical evolutions, such as cloud computing, are enabling the relocation of different types of activities, and

are maximising the synergies between geographically distant actors and teams. This is further strengthened by time zone differentials which enable Western firms to benefit from almost continuous operations.

Although India is a leader in the outsourcing of business services, it is also well known for its software industry. The limited supply of software professionals (as well as other STEM expertise) in Europe and North America also fuelled the growth of India's industry, as Western firms looked to secure knowledge inputs to satisfy demand. This has led to the development of several technology clusters in India, such as Hyderabad and Bengaluru, the latter earning the title 'the Silicon Valley of India'.

There are some disadvantages of outsourcing; the sourcing of inputs from overseas results in a reduction of jobs in home nations, home country workers can be resistant to working with back office offshore teams, and cultural differences still need to be acknowledged. Yet, offshoring presents valuable opportunities for Western firms to maximise their efficiency and productivity.

While protectionist policies and emergent capabilities to host offshore operations in other nations are on the rise, the depreciation of the rupee is bolstering India's attractiveness. However, the country's IT-BPO industry, which employed 3.7 million people in 2017, is under stark threat from artificial intelligence (AI) that could completely replace particular occupations, such as software developers. AI would not just affect offshore activities; with 9 per cent (1.4 million) jobs expected to be lost in the global IT industry by 2021, but its impacts would perhaps be most felt in specialised economies such as India's. This could result in a polarisation of offshored activities, which would constitute higher-value knowledge-intensive and customised outputs at one pole, with low-value, human capital-intensive activities such as call centres at the other.

While India still holds the crown in knowledge outsourcing, countries such as Kenya are preparing to challenge the incumbent; the Kenyan government has identified business process outsourcing as one of six priority sectors as part of its Vision 2030. For Western customers, increased competition in the market could further reduce operating costs as offshore firms compete to secure contracts and result in the increasing movement of activities abroad.

Websites: www.ca.com; www.wipro.com; www.infosys.com; www.tata.com; www.satyam.com; http://www.nasscom.in/; https://www.sramanamitra.com/2017/01/05/the-future-india-will-take-ai-

on-the-chin/; https://www.statista.com/statistics/320753/indian-it-software-and-services-exports/; https://vision2030.go.ke/economic-pillar/

Sources: http://www.nasscom.in/india-itbpm-exports, 2015; Zuhair Ahmed, 'India dismisses outsourcing fears', BBC News, 9 February 2004; 'US outsourcing is 'accelerating'', *BBC News*, 17 June 2004; Kaushik Basu, 'Outsourcing: long-term gains for all', *BBC News*, 29 March 2004; NASSCOM–McKinsey, *Extending India's Leadership in the Global IT and BPO Industries*, New Delhi, 2005.

1 Porter's well-known 1990 study on the competitive advantage of nations describes factors that have promoted high rates of innovation in certain industries in certain countries. These are summarised as the Porter diamond framework showing how factor conditions, related and supporting industries, demand conditions, and the strategy, structure and rivalry of other local firms can force continual improvements in productivity and new product development. How does the development of Indian IT fit into this framework?

2 What are the threats and opportunities for Western software firms arising from this shift in the competitive landscape? How are they strategically responding to these?

3 What factors must a firm considering outsourcing take into account?

REAL CASE

Executive search firms

Commonly known as headhunters, executive search firms (ESFs) are a specialised branch of management consulting that work directly with clients, usually MNEs, to identify, evaluate and recruit senior executives. Most *Fortune* 1,000 companies use ESFs to fill positions ranging from entry level to CEO and board member. Worldwide ESFs are an $18 billion industry. Their fees are a percentage of the salary (including equity) that the chosen candidate will receive in the first year of employment, which creates the right incentives for bargaining for high salaries by their executives. The largest firms are shown in Table 13.3. These firms are highly competitive, particularly in North America and Europe. There are also many small local boutique firms, but these often work with the major international chains for MNE recruiting.

After several years of dot.com-driven prosperity, the slowdown of the world economy hit the ESFs hard. Between 1998 and 2000, the industry enjoyed a boom with annual growth of over 20 per cent. In the United States, growth was even higher at 31 per cent in 2000. By the first few years of the new century, however, the crash of the IT industry and the US recession had reduced the number of executive spots and put a freeze on new hiring for many positions. Between 2000 and 2003, almost all ESFs were reporting losses and many headhunters were looking for work themselves. By 2004, things had started to turn around for ESFs, especially in financial services, real estate, security and construction, which once again began to hire. Since then business has picked up once again: 2006 saw a 9 per cent increase in searches and a 13 per cent increase in revenues for ESFs.

To offset the strong dependence on the business cycle, ESFs are increasingly diversifying. Korn Ferry and Heidrick & Struggles now offer strategic management assessments and executive development services. A third of Egon Zehnder International's revenues come from non-search work. The company has become a consultant for private investors who want to evaluate a firm's quality of management. Like its competitors, it has entered the human resource development business by providing mid-sized MNEs with an assessment team. In 2018, it had 450 consultants and employed over 2,600 individuals, serving client needs from 58 offices worldwide. Diversification has allowed these companies to reduce reliance on executive searches as a line of business;

branching into consulting, however, is unlikely to provide much respite for ESFs since consulting firms face similar challenges.

Alongside some degree of diversification, ESFs have significantly internationalised in recent years, following the relocation of clients and the growth of executive search services outside the triad regions. Korn Ferry, for example, has 500 consultants in 100 offices around the world and has expanded its presence in China and India considerably over the past few years. It became the largest executive-search firm after it acquired Hay Group in 2015. The deal was reportedly worth $452 million in cash and stock, and after the acquisition, the firm employed a workforce of more than 7,000 people. Research by Faulconbridge et al. has shown how the industry has evolved through several stages: organic growth after the 1960s, M&A from the late 1970s, and the development of a variety of alliance networks more recently. This expansion path has given rise to several distinctive organisational forms: the wholly owned multinational, such as Heidrick & Struggles International, Spencer Stuart and Egon Zehnder International; the networked transnational, such as the Globe Search Group; and hybrid organisations, such as Korn Ferry, which adopt either structure, depending on the market context or client needs.

Table 13.3 Top executive search firms, 2017/18

Rank	Name	Number of offices	Corporate headquarters
1	Korn Ferry	80	US
2	N2Growth	40	US
3	Heidrick & Struggles	51	US
4	Egon Zehnder	60	Switzerland
5	Spencer Stuart	50	US
6	Russell Reynolds	40	US
7	Boyden	70	US
8	Stanton Chase International	70	UK
9	TRANSEARCH	55	France
10	DHR International	50	US
11	Signium	40	US
12	Bo Le Associates	25	China
13	Odgers Berndtson	50	UK
14	IIC Partners	45	US
15	Witt/Kieffer	9	US

Note: The ranking order for the Top 20 Executive Search Firms list is derived algorithmically based upon a proprietary weighting of the following criteria: annual revenue, number of placements, number of ancillary services or practice areas, level of searches handled by average salary, completion ratio, average time to complete, stick rate, client satisfaction (testimonials/votes), social

media presence, executive thought leadership, and editorial input. Advertising payments will only affect listing by those firms who meet other qualifications noted above. The executive search industry, trade associations, and various executive search firms produce a wide array lists and rankings and no such list/ranking, including this one, should substitute for due diligence on behalf of prospective clients or employees. The rankings noted on this site are deemed reliable, but cannot be guaranteed as some of the data is provided by firms ranked on the list, and such data, especially in the case of privately held companies, can be biased and cannot be exhaustively verified.

Source: http://www.topexecutivesearchfirms.com/about/.

But analysis of the figures in *Executive Grapevine* in 2010, an annual report on headhunting, suggests that some parts of the industry began to face pressure from business networking websites such as LinkedIn, which completed a successful initial public offering in May 2011. More significant is the way that companies are using business networking websites to negotiate better rates for external searches. The report indicates that employers no longer need headhunters to put names on a shortlist. They need them to do the selling, to persuade people to move. At the top levels people are still not used to social networks. They tend to be older and once they step outside certain sectors, like technology, the social networks have not really had an impact. Headhunters themselves are divided over the impact of business networking websites. Some believe they can be useful in executive searches. Historically, it might have taken ten days or so to find a particular person who had disappeared off the radar. Now it takes you 20 seconds. Some do not believe it will replace executive search firms any time soon. Even so, some practitioners believe that the continued growth of networking websites may force headhunters out of the market at the lower end of their current business model, because they will make it hard for search firms to raise fee levels even when general market conditions improve. This would leave the headhunters even more heavily exposed to the fortunes of the high earners in the financial sector, for example in the UK, than they are already.

Websites: www.kornferry.com; www.heidrick.com; www.spencerstuart.com; www.russreyn.com; www.zehnder.com; www.hhgroup.com; www.rayberndtson.com; www.onrec.com/newsstories/; www.amrophever.com; http://www.topexecutivesearchfirms.com/about/; https://www.consultancy.uk/news/2649/korn-ferry-buys-hr-advisor-hay-group-for-452-million

Sources: James R. Faulconbridge, Sarah J. E. Hall and Jonathan V. Beaverstock, 'New insights into the internationalization of producer services: organizational strategies and spatial economies for global headhunting firms', *Environment and Planning A*, vol. 40, no. 1 (2008), pp. 210–34; www.kornferry.com; Kathy Showalter, 'Headhunting firm benefits from stable relationships', *Columbus Business First*, 19 September 2003; Alison Smith and Gill Plimmer, 'Headhunters track down fee increases', *Financial Times*, 10 July 2011.

1. When staffing the needs of the foreign subsidiary of a German company, what pool of candidates can the ESF choose from? Why would an international ESF be more capable of performing this task than the MNE's internal human resources department?
2. How would compensation negotiations differ for home-, host-, and third-country candidates?
3. What types of factors would the ESF use to identify a potential candidate for an overseas assignment?

NOTES

1 Chris Brewster and Wolfgang Mayrhofer, *Human Resource Management in Europe* (London: Routledge, 2016).
2 Anne-Wil K. Harzing and Ashley H. Pinnington (eds.), *International Human Resource Management: Managing People Across Borders*, 4th edn (London: Sage, 2017).
3 Ingemar Torbiorn, *Living Abroad* (New York: Wiley, 1982), p. 98.
4 Bernd Kupka and Virginia Cathro, ‘Desperate housewives–social and professional isolation of German expatriated spouses’, *International Journal of Human Resource Management*, vol. 18, no. 6 (2007), pp. 951–68.
5 Michael Harvey, ‘Dual career expatriates: expectations, adjustments and satisfaction with international relocation’, *Journal of International Business Studies*, vol. 28, no. 3 (winter 1997). See also Hung-Wen Lee, ‘Factors that influence expatriate failure: an interview study’, *International Journal of Management*, vol. 24, no. 3 (2007), pp. 403–13.
6 Torbiorn, *Living Abroad*, pp. 156–61.
7 B. Sebastian Reiche, Anne-Wil Harzing and Helene Tenzer (Eds.), *International Human Resource Management* (Sage publications, 2018).
8 Marion Festing, Judith Eidems and Susanne Royer, ‘Strategic issues and local constraints in transnational compensation strategies: an analysis of cultural, institutional and political influences’, *European Management Journal*, vol. 25, no. 2 (2007), pp. 118–31.

BIBLIOGRAPHY

Ahlvik, Catarina, Smale, Adam and Sumelius, Jennie. ‘Aligning corporate transfer intentions and subsidiary HRM practice implementation in multinational corporations’, *Journal of World Business*, vol. 51, no. 3 (2016).

Ahlvik, Catarina and Björkman, Ingmar. ‘Towards explaining subsidiary implementation, integration, and internalization of MNC headquarters HRM practices’, *International Business Review*, vol. 24, no. 3 (2015).

Bhanugopan, Ramudu and Fish, Alan, ‘Replacing expatriates with local managers: an exploratory investigation into obstacles to localization in a developing country’, *Human Resource Development International*, vol. 10, no. 4 (December 2007).

Bolino, Mark C. ‘Expatriate assignments and intra-organizational career success: implications for individuals and organizations’, *Journal of International Business Studies*, vol. 38, no. 5 (September 2007).

Caprar, Dan V. ‘Foreign locals: a cautionary tale on the culture of MNC local employees’, *Journal of International Business Studies*, vol. 42 (2011).

Chadwick, Clint, Guthrie, James P. and Xing, Xuejing. ‘The HR executive effect on firm performance and survival’, *Strategic Management Journal*, vol. 37, no. 11 (2016).

Chen, Stephen, Geluykens, Ronald and Choi, Chong Ju. ‘The importance of language in global teams: a linguistic perspective’, *Management International Review*, vol. 46, no. 6 (2006).

Chiang, Flora F. T. and Birtch, Thomas A. ‘Appraising performance across borders: an empirical examination of the purposes and practices of

performance appraisal in a multi-country context', *Journal of Management Studies*, vol. 47, no. 7 (November 2010).
Chung, Chul, Sparrow, Paul and Bozkurt Ödül. 'South Korean MNEs' international HRM approach: Hybridization of global standards and local practices', *Journal of World Business*, vol. 49, no. 4 (2014).
Collings, David G., Scullion, Hugh and Morley, Michael J. 'Changing patterns of global staffing in the multinational enterprise: challenges to the conventional expatriate assignment and emerging alternatives', *Journal of World Business*, vol. 42, no. 2 (June 2007).
Edwards, Tony, Sanchez-Mangas, Rocio, Jalette, Patrice, Lavelle, Jonathan and Minbaeva, Dana. 'Global standardization or national differentiation of HRM practices in multinational companies? A comparison of multinationals in five countries', *Journal of International Business Studies*, vol. 47, no. 8 (2016).
Fang, Yulin, Jiang, Guo-Liang, Frank, Makino, Shige and Beamish, Paul W. 'Multinational firm knowledge, use of expatriates, and foreign subsidiary performance', *Journal of Management Studies*, vol. 47, no. 1 (January 2010).
Farndale, Elaine, Brewster, Chris, Lighthart, Paul and Poutsma, Erik. 'The effects of market economy type and foreign MNE subsidiaries on the convergence and divergence of HRM', *Journal of International Business Studies* vol. 48, no. 9 (2017).
Fey, Carl F, Morgulis-Yakushev, Sergey, Park, Hyeon Jeong and Björkman, Ingmar. 'Opening the black box of the relationship between HRM practices and firm performance: a comparison of MNE subsidiaries in the USA, Finland, and Russia', *Journal of International Business Studies*, vol. 40 (May 2009).
Geary, John and Aguzzoli, Roberta. 'Miners, politics and institutional caryatids: Accounting for the transfer of HRM practices in the Brazilian

multinational enterprise', *Journal of International Business Studies* vol. 47, no. 8 (2016).

Gammelgaard, Jens, McDonald, Frank, Tüselmann, Heinz, Dörrenbächer, Christoph and Stephan, Andreas. 'Subsidiary role and skilled labor effects in small developed countries', *Management International Review*, vol. 49, no. 1 (2009).

Goerzen, Anthony and Beamish, Paul W. 'The Penrose effect: "excess" expatriates in multinational enterprises', *Management International Review*, vol. 4, no. 2 (2007).

Gooderham, Paul N., et al. 'National and firm-level drivers of the devolution of HRM decision making to line managers', *Journal of International Business Studies* (2015).

Holtbrügge, Dirk and Mohr, Alex T. 'Subsidiary interdependencies and international human resource management practices in German MNCs', *Management International Review*, vol. 51, no. 1 (2011).

Iles, Paul, Xin Chuai and Preece, David. 'Talent management and HRM in multinational companies in Beijing: definitions, differences and drivers', *Journal of World Business*, vol. 45, no. 2 (2010).

Kirkman, Bradley L., Lowe, Kevin B. and Gibson, Cristina B. 'A quarter century of *Culture's Consequences*: a review of empirical research incorporating Hofstede's cultural values framework', *Journal of International Business Studies*, vol. 37, no. 3 (March 2006).

Kostova, Tatiana, Valentina Marano and Stephen Tallman. 'Headquarters–subsidiary relationships in MNCs: fifty years of evolving research', *Journal of World Business*, vol. 51, no. 1 (2016).

Lawler, John J., Chen, Shyh-jer, Wu, Pei-Chuan, Bae, Johngseok and Bing Bai, Bing. 'High-performance work systems in foreign subsidiaries of American multinationals: an institutional model', *Journal of International Business Studies*, vol. 42 (October 2010).

Mäkelä, Kristiina, et al. ‘Determinants of strategic HR capabilities in MNC subsidiaries’, *Journal of Management Studies*, vol. 49, no. 8 (2012).

Maloney, Mary M. and Zellmer-Brun, Mary. ‘Building bridges, windows and cultures: mediating mechanisms between team heterogeneity and performance in global terms’, *Management International Review*, vol. 46, no. 6 (2006).

Minbaeva, Dana, et al. ‘MNC knowledge transfer, subsidiary absorptive capacity and HRM’, *Journal of International Business Studies*, vol. 45, no. 1 (2014).

Morris, Shad S. and Snell, Scott A. ‘Intellectual capital configurations and organizational capability: an empirical examination of human resource subunits in the multinational enterprise’, *Journal of International Business Studies*, vol. 42 (August 2011).

Newenham-Kahindi, Aloysius. ‘Human resource strategies for managing back-office employees in subsidiary operations: the case of two investment multinational banks in Tanzania’, *Journal of World Business*, vol. 46, no. 1 (2011).

Nielsen, Sabina. ‘Top management team internationalization and firm performance’, *Management International Review*, vol. 50, no. 2 (2010).

Reiche, B. Sebastian, Kraimer, Maria L. and Harzing, Anne-Wil (Eds.), *International Human Resource Management* (Sage publications, 2018).

Reiche, B. Sebastian, Kraimer, Maria L. and Harzing, Anne-Wil. ‘Why do international assignees stay? An organizational embeddedness perspective’, *Journal of International Business Studies*, 42 (May 2011).

Smale, Adam, Björkman, Ingmar and Sumelius, Jennie. ‘Examining the differential use of global integration mechanisms across HRM practices: evidence from China’, *Journal of World Business*, vol. 48, no. 2 (2013).

Taylor, Sully. ‘Creating social capital in MNCs: the international human resource management challenge’, *Human Resource Management*

Journal, vol. 17, no. 4 (2007).

Thomas, David C., Lazarova, Mila B. and Inkson, Kerr. ‘Global careers: new phenomenon or new perspectives?’ *Journal of World Business*, vol. 40, no. 4 (November 2005).

Tung, Rosalie L. ‘Selection and training procedures of US, European, and Japanese multinationals’, *California Management Review*, vol. 25, no. 1 (1982), pp. 57–71.

Williams, Christopher and Soo Hee Lee. ‘Knowledge flows in the emerging market MNC: The role of subsidiary HRM practices in Korean MNCs’, *International Business Review*, vol. 25, no. 1 (2016).

Yamazaki, Yoshitaka. ‘Expatriate adaptation’, *Management International Review*, vol. 50, no. 1 (2010).

Zellmer-Bruhn, Mary and Gibson, Cristina. ‘Multinational organization context: implications for team learning and performance’, *Academy of Management Journal*, vol. 49, no. 3 (June 2006).

Chapter 14

POLITICAL RISK AND NEGOTIATION STRATEGY

Contents

Objectives of the chapter

For international managers, different countries represent different business contexts with new opportunities and risks. Political change, whether gradual or sudden, can be a source of both, and

tends to be a particularly important factor in emerging and developing countries. Changes in institutions, governance systems and business-related legislation are frequent in such countries and can radically change the local ‘rules of the game’. An important management priority is to fully assess the risks as well as the potential rewards before and after investing in these kinds of new markets. Major political changes in China and India in the early 1990s, for example, opened up these economies for foreign investors. They had always been attractive markets, but were made accessible by government-led liberalisation. However, the high level of control still held by these governments over their economies, combined with the continued uncertainty regarding political change, results in a high level of political risk for investors.

Beyond these major political shifts, smaller changes in any government’s policies towards foreign investors – from taxes and tariffs to profit repatriation to local input content to employment legislation to corporate governance practices – can tilt the balance between profit and loss.

This chapter examines political risk in the context of overall country risk assessment. We look at how multinational enterprises (MNEs) try to forecast this risk, how they can understand governments’ policy agendas, and how they can use negotiating tactics to minimise their political risk.

The specific objectives of this chapter are to:

1. *Examine* the nature of political risk.
2. *Understand* how to apply some of the tools and resources that companies can use to measure and forecast political risk.
3. *Discuss* some of the ways that firms manage risk.
4. *Review* typical strategies and tactics used in negotiating agreements.

ACTIVE LEARNING CASE

Nestlé in Nigeria

Nestlé is one of the largest food and drink companies in the world and is headquartered in Vevey, Vaud, Switzerland. As of 2018, Nestlé has operations in 190 countries, 414 factories in 85 countries, and almost 310,000 employees. In 2018, the firm secured approximately $90 billion revenue, of which 34.1 per cent was from Europe, Middle East and North Africa, 33.9 per cent from North, South and Central America, and 32 per cent from Asia-Pacific. It first entered the Nigerian market as a trading company in 1961 and has recently invested over $500 million to expand its operations. In 2014/15 it focused on a major project investing $28 million for bottled water production across a distributed set of plants near the main cities, under the 'Nestlé Pure Life' brand. It has also expanded the Nestlé Flowergate Factory, a Maggi production facility near Sagamu in the Nigerian state of Ogun. This was opened in 2011 and employs approximately 3,200 people. Moreover, the factory indirectly employs around 1,500 people, including farmers, distributors and suppliers. The Maggi brand is part of Nestlé's food seasoning and culinary products division and is also very popular in India.

Nigeria is a country of contrasts. It has a GDP estimated around $380 billion, making it the largest economy in Africa, and marginally larger than South Africa. It has been listed among the 'MINT' countries (Mexico, Indonesia, Nigeria and Turkey), seen as the next group of large, fast-growing economies after the BRICs (Brazil, Russia, India and China). It also boasts Africa's richest man, Aliko Dangote, whose $23 billion-plus industrial conglomerate produces cement, flour and sugar, while 60 per cent of his 175 million countrymen live in severe poverty. Literacy rates and mortality rates are very low, placing Nigeria firmly in the developing country category.

One of the earliest attractions for foreign firms investing in Nigeria was the local oil industry. It is the biggest oil exporter in Africa and has the largest natural gas reserves in the continent. This industry is currently suffering from the downturn in global prices, but theft and corruption have also undermined the development of the industry, forcing many foreign investors to close down operations. More recently, strong growth in cell phones (it has 70 per cent mobile penetration),

banking and the ‘Nollywood’ movie industry have attracted inward investment via joint ventures and alliances.

Local purchasing power is also growing. According to the African Development Bank (ADB), the Nigerian middle class consists of 23 per cent of the population with average households having a monthly income ranging between $600 and $850. This buying power is a key attraction for Nestlé and a wide range of global consumer products companies. The food and beverages sectors, key to Nestlé, grew by 60 per cent between 2007 and 2011.

But entering this market and operating a business in Nigeria carries significant risks for multinational firms, compared to other country markets. Underdeveloped infrastructure, weak institutions and cultural and social tensions all add to the normal complexities of management. In the World Bank’s ‘ease of doing business’ rankings, it is listed at 146 out of 190.

The poor energy infrastructure (ranked 171 out of 187 countries for ‘getting electricity’ in the above ranking) means that to avoid outages manufacturers have to establish a reliable alternative source of power. This can cost 25 per cent of their overall start-up costs. The weak transport infrastructure adds to the costs of product distribution and has risen by 15 per cent in the past two years. For Nestlé specifically, distribution and selling expenses have grown ahead of turnover at 11 per cent over the past few years, as have the cost of sales, by 8.6 per cent. Finally, like other firms it is dependent on imports. Inefficient transport facilities combined with corrupt officials create expensive delays. Goods that are not fast-tracked are said to take about 60 days at the port in Lagos. Predicting which costs will grow and how quickly is a key to estimating future profitability or economic viability for foreign investors.

Economic inefficiency, uncertainty and instability in Nigeria are exacerbated by a range of political risks. Nigeria’s 200 ethnic groups, 500 indigenous languages and complex regional politics underpin long-running tensions alongside the more recent impact of Islamist insurgents. Religious terrorist activity tended to affect the poorer northeast in the past, but has recently struck in the capital, Abuja. There have been thousands of deaths in the past couple of years and a large number of kidnappings, including the 200 schoolgirls taken by the infamous Boko Haram sect in 2014, as well as the 2015 Zaria massacre where the Nigerian army opened fire on a minority group who were conducting a religious procession.

Corruption is also a major hurdle for all managers, foreign and local. Transparency International ranks Nigeria 144 out of 180 in its 'Corruption Perception Index' and the 'misuse of public power for private gain' affects business at the national and local levels. In a long-running scandal over oil revenues, the Central Bank governor, Lamido Sanusi, was suspended after exposing a multibillion-dollar hole in the oil accounts. Despite assurances President Goodluck Jonathan's administration was unable to answer whether $3 billion, $10 billion or $20 billion was missing! In 2015 Goodluck's administration was replaced by one led by Muhammadu Buhari.

Nestlé is one among a group of mature multinationals in Nigeria, including Heineken, Cadbury's and Unilever, and more recently General Electric, Procter & Gamble and Nissan, that have learned to cope with such uncertainties. They have the people, resources and experience to mitigate the severest risks and adapt as Nigeria develops into a mature economy.

Sources: 'Investing in Nigeria', *Financial Times*, 5 May 2014; Thando Matutu, '$28 million boost for Nestlé Nigeria', *CNBC Africa*, 12 February 2015; https://www.transparency.org; http://www.worldbank.org/en/country/nigeria; http://www.nestle.com/asset-library/documents/library/documents/about_us/quick-facts-2014-en.pdf; http://www.doingbusiness.org/reports/global-reports/~/media/GIAWB/Doing%20Business/Documents/Annual-Reports/English/DB15-Chapters/DB15-Country-Tables.pdf; http://www.doingbusiness.org/data/exploreeconomies/nigeria; http://www.doingbusiness.org/en/data/exploretopics/getting-electricity; https://www.transparency.org/cpi2018; Nestlé Annual Report 2018; http://en.abna24.com/service/africa/archive/2015/12/15/724986/story.html.

1. **Why has Nestlé increased its investments in Nigeria in recent years?**
2. **What kinds of country risks have Nestlé and other MNEs faced when doing business in Nigeria?**
3. **What are the pros and cons of MNE investment for Nigeria as a nation?**

4 **What are the lessons for other firms looking to invest in developing countries like Nigeria?**

INTRODUCTION

A range of strategy frameworks in this book – such as the strategy matrix, Porter's value chain, competitor analysis and Porter's five forces – help managers understand their competitive environment and identify their firm's unique competitive advantages. Country risk analysis can build on these approaches by providing insights into the country-level factors that will affect the leveraging of these advantages in a particular country, and help managers balance potential risks against rewards. **Country risk analysis** examines the chances of non-market events (political, social and economic) causing financial, strategic or personnel losses to a firm following FDI in a specific country market. Rather than looking at a market, industry or group of competitors, country risk analysis tries to predict macroeconomic and political sources of change that might undermine a firm's position in a local market.[1] This kind of analysis is used to compare country markets before making investment decisions. Decision-makers supplement strategic information about market size, market growth, presence of local suppliers, support industries and the strengths of local competitors with, for example, estimates of current and future socio-economic and political risks that are country specific. In this chapter, we will particularly examine political risk, but first we will examine a well-known, general framework for analysing and comparing country conditions: PEST analysis.

Generic PEST analysis

One of the simplest, most general and multidisciplinary frameworks for understanding change at the broadest level is the **PEST framework** (Figure 14.1). This is used to map out particular competitive environments or

investment *contexts* for firms at the regional or national level, compare country conditions and build future scenarios to understand short-term and long-term threats and opportunities. Influential factors are divided into political, economic, social or socio-cultural, and technological (PEST), which in combination create particular opportunities and threats for firms. PEST can be extended to PESTLE by adding legal factors, reflecting national legislative institutions and policies, and environmental factors, including local policies on waste and pollution. It can be used specifically to assess new investment environments as an input into global expansion and market-entry strategies.

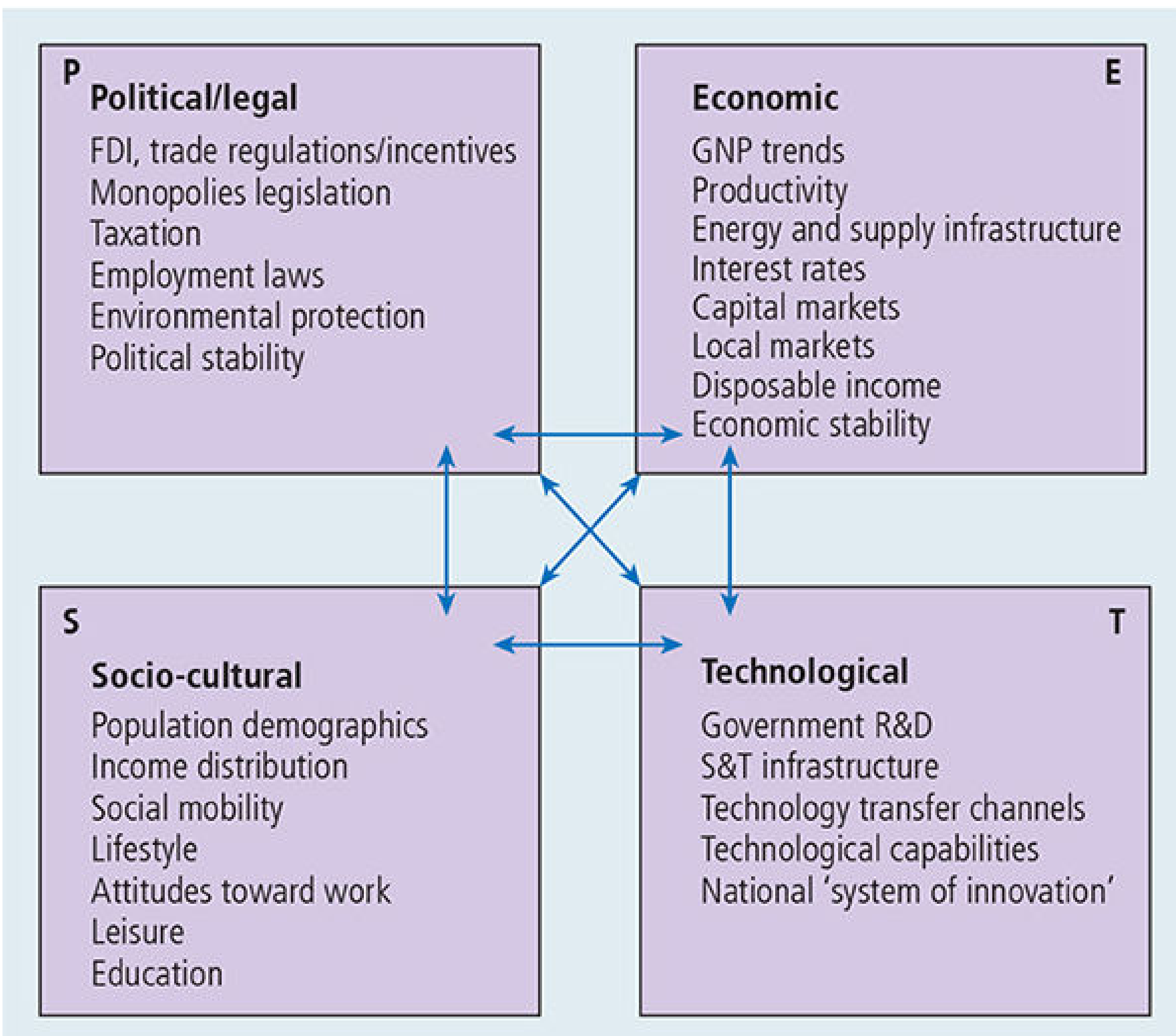

Figure 14.1 **PEST framework for country analysis**

Clearly, there are strong interactions between the categories of factors. Political developments have a strong influence over economic change, particularly in emerging markets like China. Similarly, economic, social and technological factors are interdependent. However, the PEST breakdown makes the task of analysing a complex range of influences more manageable.

On the face of it, this kind of framework may look too general and simple to guide management strategy. The general PEST overview shown above, however, is just a starting point to organise more focused analyses. Rigor can be added and accuracy improved in two ways:

1 *Add depth.* To fully understand the nature of the changes taking place within each of the categories, further tools and techniques are needed:

- Political scientists and analysts conduct formal risk assessments on political change within regions or countries. Formal rankings are published to guide investors along the same lines as insurance assessors (see related discussions later in this chapter). Such analyses also map out the key political constituencies, central and regional agencies, key ministers and bureaucrats, as well as changing forms of legislation in different countries as an input into MNE strategy and implementation (for example, aiding the development of personal contacts and networks in target countries).
- Economic analyses cover everything from national-level to industry-sector or market-specific trends. Companies compiling return on investment (ROI) projections need to know something about productivity levels that can be expected in would-be plants,

encompassing data on employees, technologies, support industries, local utilities, and so on. Any investment that relies on some element of local financing will need data on local interest rate trends, lending conditions and the general stability of domestic capital markets, for example.

- Social trends analyses are relevant for firms looking to market new products and services in new countries. Mapping patterns of disposable income, customer preferences and regional differences in these requires a combination of quantitative and qualitative analyses. Statistical overviews covering demographics, buying patterns and market research need to be complemented with insights into socio-cultural norms and changing patterns of expectations if advertising messages are to be pitched correctly.

2 *Add foresight.* Arguably the most difficult challenge facing any decision-maker is to predict the future. The complexity that results from the variety of factors that managers need to consider when making international business decisions adds immeasurably to this uncertainty. Accurate scenario building is central to the strategic planning and future success of any firm and can be done using the PEST framework as a starting point. Rather than creating grandiose visions of the future, managers need to extrapolate accurately and objectively from the past and current trends across all the PEST dimensions to map out the likelihood of different futures and the implications of these for particular global strategies.

Active learning check

Review your answer to Active Learning Case question 1 and make any changes you like. Then compare your answer to the one below.

1 Why has Nestlé increased its investments in Nigeria in recent years?

A PEST analysis would suggest that favourable economic and socio-cultural trends are most relevant to Nestlé's decision to increase investment in specific product lines. Higher levels of disposable income and a growing middle class are key attractions, alongside a 7 per cent growth in GDP. We should note that the company also uses Nigeria as a base to export to other parts of Africa, where similar trends exist. Technological trends are less relevant, although better local support for customising products in general and specifically for supporting the firm's investment in clean water production could be cited.

Political trends are probably unfavourable to further investment, given the failure of the government to deal decisively with terrorist groups at one level, or endemic corruption at another. However, Nigeria's position in the World Bank's 'ease of doing business' rankings has improved from 175/189 in 2014 to 146 in 2018. Given that Nestlé is investing in the country, we can only assume its senior management feels that the positives outweigh the negatives.

POLITICAL RISK

This is the Chinese character for 'risk'. The first symbol is for 'danger', the second symbol is for 'opportunity'. Risk is seen as danger and opportunity combined.

Political risk is the probability that political forces will negatively affect a firm's profit or impede the attainment of other critical business objectives. The study of political risk addresses changes in the environment that are difficult to anticipate. Common examples include the election of a government that is committed to nationalisation of major industries or one that insists on reducing foreign participation in business ventures.

Most people believe that political risk is confined to Third World countries or to those with unstable governments. However, the shifting policies of triad region governments illustrate that political risk is also an issue for firms doing business in highly industrialised nations. Governments routinely protect key industries for reasons of national security, self-sufficiency or national culture. Examples include US restrictions on foreign investment in the banking, defence and commercial airline industries; Japanese protection of its rice producers; and France's limitations on foreign involvement in its movie and media businesses. The EU and US governments have long supported their regional champions in the aerospace industry, partly for security reasons, partly to protect local firms. Airbus spent $11 billion on building the A380 double-decker jumbo jet, one-third of

which came from European taxpayers. This exacerbated the trade battles in this industry, refereed by the WTO.

Much of this political sparring is predictable. It is unanticipated change stemming from complexity and uncertainty that creates more dangerous kinds of risk. However, these examples indicate the pervasiveness of political risk. Given the large number of international markets in which MNEs operate, political risk is going to remain an area of concern. In dealing with this issue, effective negotiating can help to reduce and contain problem areas. This will be explained later in the chapter.

Deregulation and political risk

The post-second world war period saw a general, long-term trend towards liberalisation, deregulation and the opening up of national borders to trade and FDI, as a major driver of globalisation. As shown in Table 14.1, this started to change in the early-mid-2000s and a more mixed picture developed.

The large number of regulatory changes that were favourable to FDI, associated with the progressive liberalisation of countries with large domestic markets and extensive privatisation or denationalisation programmes underway, such as China, Brazil and India, significantly changed the global economy. Chapter 19, on emerging economies, provides data on trade and FDI flows into these regions at this time. But this period ended and more recently, particularly under the Trump administration in the USA, some Western industrialised countries have started to strengthen protectionist measures and restrict domestic market access in some sectors from foreign competitors.

For these giant emerging markets, major political shifts in the 1970s and 1980s led to the start of the process of integrating with the global economy and the opening up of their borders to foreign investors. This process is

ongoing and continuous changes to their policies and legislation regarding FDI and the activities of MNEs mean that ongoing assessments of political risk in these countries are of paramount importance to investors. The governments of these countries, together with their massive, complex civil service bureaucracies, maintain a strong level of control over their economies, and the direction and pace of change remains unpredictable.

Table 14.1 Changes in national regulations on FDI, 2003–17

Changesin National Investment Policies, 2003–2017 (Number of measures)															
Item	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
Number of countries that introduced changes	59	79	77	70	49	40	46	54	51	57	60	41	49	59	65
Number of regulatory changes	125	164	144	126	79	68	89	116	86	92	87	74	100	125	126
Liberalization/ promotion	113	142	118	104	58	51	61	77	62	65	63	52	75	84	93
Restriction/regulation	12	20	25	22	19	15	24	33	21	21	21	12	14	22	18
Neutral/ indeterminatea	—	2	1	—	2	2	4	6	3	6	3	10	11	19	15

Source: UNCTAD, Investment Policty Monitor Database.

*In some cases, the expected impact of the policy measure on the investment is undetermined

The nature of political risk

We can examine political risk at two different levels, as seen in Figure 14.2. Legal/governmental risks are potentially harmful to foreign businesses but are the product of, or permissible within, the existing political, economic and legislative system. Non-legal or extra-governmental risks lie outside this system and are a violation of existing laws. Macro-level risks affect all foreign firms evenly, and micro-level risks harm individual or specific groups of firms.

Macro political risk

A **macro political risk** is one that affects all foreign enterprises in the same general way. **Expropriation**, the governmental seizure of private businesses coupled with little, if any, compensation to the owners, is an example of a macro political risk. Communist governments in eastern Europe and China expropriated private firms following World War II. Fidel Castro did the same in Cuba from 1958 to 1959. In more recent years, governments in Angola, Chile, Ethiopia, Peru and Zimbabwe have expropriated private enterprises. In some cases, this stems from **indigenisation laws**, which require that nationals hold a majority interest in all enterprises. The privatisation of a range of state-owned industries in Russia marked a turning point in that country's history. However, the corruption and racketeering that led to politically connected individuals building massive fortunes from, for example, the oil and aluminium industries may have triggered another turning point. The government has threatened to re-nationalise key industries.

Micro political risk

A **micro political risk** is one that affects selected sectors of the economy or specific foreign businesses. These risks are typically a result of government action in the form of industry regulation, taxes on specific types of business activity and local content laws.

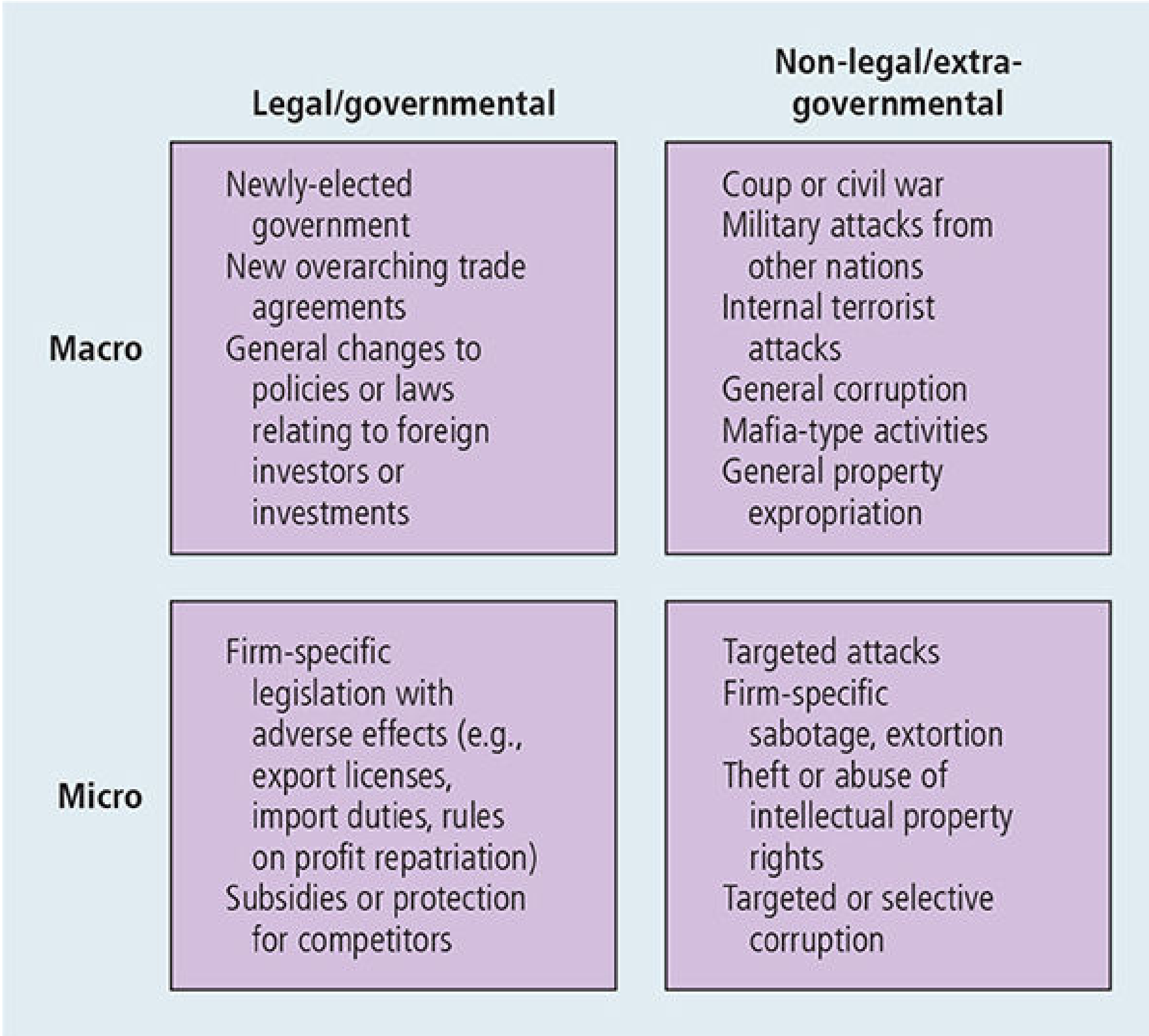

Figure 14.2 Types and levels of political risk

A number of factors help to determine the degree of micro political risk. One is the dominance of foreign firms or the growing competitiveness of their products in an industry. For example, small and medium-sized makers of precision tools for the electronics industry in the United States have joined forces to lobby for higher tariffs on imports that compete with their products, including those made by large US firms offshore. Prompted by the growing trade deficit and job losses in manufacturing, they have used the National Association of Manufacturers to push the government to defy WTO

regulations and protect their particular businesses by increasing specific tariffs.

Political and strategic reasons also prompt governments to act. The European Union has recently increased its selective protectionism towards Chinese firms looking to acquire high-technology firms that are seen to have valuable new technologies or a strategic position in supply chains to European defence or aerospace manufacturers. The USA, EU and China have all recently taken steps to protect local car manufacturers against foreign competitors. This is partly in response to new emerging overseas competitors, but also driven by local concerns about the decline in manufacturing jobs.

Some political risks are predictable and can be partly planned for. Others are not and tend to have a more significant effect. The changing priorities of governments, often swayed by powerful interest groups, are an important source of this kind of risk. As discussed below, governments have specific economic, social and often military agendas, and changes in these will result in adjustments to the various levers that control trade and the activities of foreign investors.

Sources of political risk

There are a number of sources of political risk. Table 14.2 presents some important sources and their effects. A variety of motivations help to explain political risk. The MNE's challenge is to identify these motivations and then to decide how to manage them.

Table 14.2 Political risk: sources, agents and effects

Sources of political risk	Groups that can generate political risk	Effects of political risk
Political philosophies that are changing or are in competition with each other	Current government and its various departments and agencies	Expropriation of assets (with or without compensation)

Changing economic conditions	Opposition groups in the government that are not in power but have political clout	Indigenisation laws
Social unrest	Organised interest groups such as teachers, students, workers, retired persons, etc.	Restriction of operating freedom concerning, e.g. hiring policies and product manufacturing
Armed conflict or terrorism	Terrorist or anarchist groups operating in the country	Cancellation or revision of contracts
Rising nationalism	International organisations such as the World Bank and the United Nations	Damage to property and/or personnel from terrorism, riots, etc.
Impending or recent political independence	Foreign governments that have entered into international alliances with the country or that are supporting opposition to the government	Loss of financial freedom such as the ability to repatriate profits
Vested interests of local business groups	—	Increased taxes and other financial penalties
Competing religious groups	—	—
Newly created international alliances	—	—

COUNTRY ANALYSIS AND POLITICAL RISK ASSESSMENT

As described above, the PEST framework provides a simple way of mapping the pros and cons of foreign investment opportunities in particular countries for MNEs. There are many other analytical tools and techniques to measure the cost–benefit or risk–reward ratio for a specific investment proposition. These range from scenario planning, Delphi exercises and multivariate risk analyses to simple observation. The degree to which companies actually use these techniques before investing abroad varies a great deal.

Small firms, especially owner-managed firms, often move from simple exporting to engage in FDI on the basis of the owner, CEO or senior manager seeing an opportunity when on holiday in a foreign country! Little or no rigorous risk analysis or comparison of opportunities between countries is conducted, partly because it takes time and is expensive, but often because managers are unaware of the need for analysis and/or ignorant of the tools, techniques and information resources that can help them make these decisions.[2] Most firms, however, will conduct some level of analysis to capture the likely costs and benefits and probable risks relating to a particular overseas investment.

There are many sources of information on the PEST conditions in different country markets for use in comparative risk analysis. Country risk rating services are provided by a range of agencies that produce general reports and may conduct specific analyses on behalf of client companies. Such agencies include the Bank of America World Information Services, the Business Environment Risk Intelligence (BERI) SA, the Control Risks Information Services (CRIS), the Economist Intelligence Unit (EIU),

Standard & Poor's Ratings Group, the Political Risk Services (ICRG) and Moody's Investor Services.

BERI political risk services, for example, began in 1966 using 15 variables, such as bureaucratic delays, monetary inflation and political stability, to 'isolate to the degree possible the political process affecting business'. It contained a weighting to emphasise certain criteria (such as political stability) over others in terms of their significance and impact. The sum of the weights was 25 and each of the 15 factors was then scored at four times its weight, so the highest possible points and lowest risk was 100. A global panel of experts (although US-based experts dominated) then assessed the score for each variable in a Delphi-style validation to help rank 40 to 50 countries according to the resulting consensus. Scores between 70 and 56 were defined as moderate risk, denoting overall stability despite the varied risk of complications that might affect day-to-day operations for businesses. Any country with a rating under 56 was considered unstable.

The FORCE Country Reports from BERI also provide a qualitative analysis of socio-political, economic and financial forecasts. They include scenario analyses and so-called political, operations and remittance/repatriation risk indices and profit opportunity recommendations (POR). The BERI risk measurement components include several categories of information, such as political factionalisation, linguistic/ethnic/religious tension, coercive measures to maintain the regime, prevalence of corruption, radical left strength, dependence on major external power, and so on.[3]

Online risk information resources

An increasing number of country rating and indexing schemes are available online. One of the best is the World Bank and IMF site (https://datacatalog.worldbank.org/dataset/doing-business), which is a useful resource for off-the-shelf reports, such as *Doing Business* in country X this

year. But it also allows users to create customised reports using an online database of indicators across 189 economies. This is linked to specialised topic areas covering practical guidelines for investing and managing in different countries, including Starting a Business, Hiring and Firing Workers, Enforcing Contracts, Getting Credit, and Licensing and Inspections. The World Bank's Multilateral Investment Guarantee Agency (MIGA) is also a good source (http://miga.org). Table 14.3 provides a list of countries ranking according to the cost or ease of doing business for foreign firms. The actors listed represent some of the commonest practical or operational steps that managers need to deal with when they enter these country markets.

One of the most widely used and well-respected sources of information is the Economist Intelligence Unit (EIU) (www.eiu.com). Alongside fairly general information it has a host of interactive services, most of which are for subscribers only. It also describes some of the indicators and the methodology underlying its Country Risk Service.

The Fraser Institute, with its very overt political view, compiles the Index of Economic Freedom (http://www.fraserinstitute.ca and http://www.freetheworld.com). This compares 23 components across seven areas (economic structures, monetary policy, etc.) to measure the degree to which host-country institutional arrangements and policies intervene in or influence the operation of the economy. It also attempts to assess how predictable these arrangements and policies are and therefore how important they are as a source of market uncertainty.

PricewaterhouseCoopers (PwC) compiles an opacity index, which is closer to the kinds of analyses that examine non-legal activities by governments that might influence or intervene in business. This measures the impact of business, economic, legal and ethical opacity on the cost of capital around the world.

Finally, as an indication of the importance of these kinds of analyses, the World Economic Forum (WEF) has developed a Public Institutions Index as an input for its overall annual global competitiveness ranking (http://reports.weforum.org). This index comprises a Contracts and Law sub-index (covering judicial independence, property rights, organised crime, favouritism in government decision making) and a Corruption sub-index (including irregular payments for imports and exports, tax collection and public utilities).

Quantifying risk vulnerability

As shown by the above risk ratings services, all risk is relative. Measuring risk therefore involves comparing options, one investment proposition against another. This means combining investment appraisal and country appraisal techniques. There are factors that may be more important for one kind of investment than another – a production plant will have different requirements from a distribution or marketing operation, or an offshore IT service office, for example. Therefore different risk criteria are more or less relevant at the country level. Table 14.4 shows the **Weighted Country Risk Assessment Model** for combining both.

Two different country cases (A and B) are compared using 30 different criteria; 15 are political in nature and 15 are economic, although many of the latter are also directly or indirectly influenced by the governments. The Risk column gives a rating (1 is low risk; 5 is high) comparing Country A and Country B on this criterion and can represent either a direct comparison (for example, high or low current disposable income levels) or a risk measure – the potential for change that would harm the investment proposed (for example, the likelihood that disposable income levels will fall significantly in the future). So, for example, Country A is rated as more politically stable than B and has a lower likelihood of internal conflicts, more predictable

policies, a more stable tax and tariff regime, and fewer (less likelihood of) bureaucratic delays. Economically, the two countries are a little more similar, although Country A, for example, clearly rates higher in terms of upholding intellectual property rights, so there is less risk of breaches of copyright, patents or brands. They have fairly similar domestic economic environments in terms of the listed criteria, with Country A having experienced better growth in the past five years, but expecting the same growth prospects as B for the next three years. This relative country rating across the three categories is summarised by the totals at the foot of the table: 67 for Country A and 101 for Country B.

Table 14.3 The cost/ease of doing business: cross-country comparisons

Economy	Ease of doing business rank	Starting a business	Dealing with construction permits	Getting electricity	Registering property	Getting credit	Protecting minority investors	Paying taxes	Trading across borders	Enforcing contracts	Resolving insolvency
New Zealand	1	1	6	45	1	1	2	10	60	21	31
Singapore	2	3	8	16	21	32	7	8	45	1	27
Denmark	3	42	4	21	11	44	38	9	1	14	6
Hong Kong SAR, China	4	5	1	3	53	32	11	1	27	30	44
South Korea	5	11	10	2	40	60	23	24	33	2	11
Georgia	6	2	27	39	4	12	2	16	43	8	60
Norway	7	22	22	19	13	85	15	30	22	3	5
United States	8	53	26	54	38	3	50	37	36	16	3
United Kingdom	9	19	17	7	42	32	15	23	30	32	14
Macedonia, FYR	10	47	13	57	46	12	7	31	29	37	30
United Arab Emirates	11	25	5	1	7	44	15	2	98	9	75
Sweden	12	18	25	9	10	85	33	27	18	38	17
Taiwan, China	13	20	2	8	19	99	15	29	58	11	23
Lithuania	14	31	7	26	3	44	38	18	19	7	85
Malaysia	15	122	3	4	29	32	2	72	48	33	41
Estonia	16	15	14	46	6	44	83	14	17	13	47
Finland	17	43	34	25	28	60	72	11	34	46	2
Australia	18	7	9	52	50	8	64	26	103	5	20
Latvia	19	24	56	53	25	12	51	13	26	20	54
Mauritius	20	21	15	34	35	60	15	6	69	27	35
Iceland	21	59	71	13	15	73	30	33	53	31	12
Canada	22	3	63	121	34	12	11	19	50	96	13
Ireland	23	10	28	43	64	44	15	4	52	102	18
Germany	24	114	24	5	78	44	72	43	40	26	4
Azerbaijan	25	9	61	74	17	22	2	28	84	40	45
Austria	26	118	42	28	32	85	33	40	1	10	21
Thailand	27	39	67	6	66	44	15	59	59	35	24
Kazakhstan	28	36	35	76	18	60	1	56	102	4	37

Source: http://www.doingbusiness.org/ranking, 2018.

Table 14.4 The weighted country risk assessment model

		Selected criteria	Country A			Country B		
			Risk (5 = high)	Importance (5 = high)	Combined score (/25)	Risk (5 = high)	Importance (5 = high)	Combined score (/25)
Political environment	1	Stability of the local political system	2	4	8	4	4	16
	2	Likelihood of internal conflict	1	4	4	4	4	16
	3	External threats to stability	3	3	9	3	3	9
	4	Harmful government intervention in the economic system	1	4	4	4	4	16
	5	Reliability of the country as a trading partner	3	4	12	3	4	12
	6	Policy continuity/predictability	2	5	10	4	5	20
	7	Stability of tax and tariff regime	1	4	4	3	4	12
	8	Effectiveness of public administration	2	3	6	3	3	9
	9	Prevalence of corruption	1	3	3	5	3	15
	10	Bureaucratic delays	1	4	4	5	4	20
	11	Enforceability of contracts	2	4	8	4	4	16
	12	Corporate governance and ethics legislation	3	2	6	4	2	8
	13	Labour unions and labour relations	3	5	15	3	5	15
	14	Linguistic/ethnic/religious tensions	2	1	2	3	1	3
	15	Social stability	2	2	4	3	2	6
International economic environment	16	Import restrictions	4	4	16	4	4	16
	17	Export restrictions	3	5	15	3	5	15
	18	Attitudes toward foreign investors	2	3	6	3	3	9
	19	Respect for intellectual property rights (patents, brands)	2	4	8	5	4	20
	20	Restrictions on monetary transfers	3	5	15	3	5	15
	21	Revaluation of the currency during the last 5 years	3	2	6	4	2	8
	22	Balance of payments situation	2	2	4	2	2	4
Domestic economic environment	23	Per capita income	3	1	3	3	1	3
	24	Economic growth over the last 5 years	2	1	2	4	1	4
	25	Potential growth over the next 3 years	2	1	2	2	1	2
	26	Inflation over the past 2 years	3	3	9	4	3	12
	27	Accessibility of domestic capital markets to outsiders	2	4	8	2	4	8
	28	Availability of high-quality local labour force	2	5	10	2	5	10
	29	Availability of energy resources	2	4	8	2	4	8
	30	Infrastructure: transportation and communication systems	3	4	12	3	4	12
		TOTALS	67	100	223	101	100	339

Sources: The approach and the items in the table were developed by Simon Collinson, drawing from prior risk assessment models and studies, including D. W. Conklin, 'Analyzing and managing country risks', *Ivey Business Journal*, vol. 66, no. 3 (January/February 2002), pp. 36–42; S. T. Cavusgil, 'Measuring the potential of emerging markets: an indexing approach', *Business Horizons*, vol. 40, no. 1 (1997); A. I. J. Dyck, *Country Analysis* (Boston, MA: Harvard Business School Press, 1997); and E. Dichtl and H. G. Köglmayr, 'Country risk ratings', *Management International Review*, vol. 26, no. 4 (1986), pp. 4–12. This latest version of the framework benefited from the advice and feedback of Professor Derek Condon, Professor of International Business and Corporate Governance, Birmingham Business School.

The Importance column rates each of the same 30 criteria in terms of relevance to the kind of investment proposed. This example has been designed to reflect an overseas investment for a production facility, mainly for exports. Criteria such as export restrictions, the availability of high-quality labour, the stability of taxes and tariffs, policy continuity, bureaucratic delays and enforceability of contracts, for example, are considered important (rating 5 or 4). Economic growth and per capita income, for example, are considered less important. These would be important if we were considering a sales and distribution operation for consumer products. As this illustration shows a country comparison, not a comparison of different types of investment, the Importance columns for Country A and Country B are identical. If we were to compare types of investment, we would change the ranking of the various criteria (between 1 and 5), but the total for this column would still need to add to 100, otherwise the weighting method would not work. In this case we would simply be changing the *relative* importance of different risk factors to suit a different type of investment proposition.

The combined score weights each country criterion according to respective importance to the type of investment under consideration, and the combined totals provide an overall comparison of the two countries. The higher the final score, the riskier the combination of investment and location. Country A, with 223 out of a possible 500, appears to be a better option for this kind of investment than Country B with 339.

Table 14.4 presents a fairly basic example. The list of criteria can be changed and extended to far more than 30 and sub-criteria (for example, different kinds of bureaucratic delays under item 10) can be added. The balance among political, economic, social, technological and legal criteria can also be altered according to the investment proposition and/or the countries to be considered. We could also use a different Likert scale, such

as from 1 to 10 rather than 1 to 5. The model can be extended to compare more than two country cases. For any extension of the model, it is important to remember that the ratings are *relative*. For example, the above-mentioned BERI political risk ratings show Zimbabwe as riskier than Peru. We might give the former 5 for some of the political criteria in the Risk column and the latter a comparative 2 or 3. If we were to add Sweden to the comparison, the rating in the Risk column would need to reflect the change, perhaps by giving Zimbabwe and Peru 5 in some categories and Sweden 1. So the rating scores are not absolute. They depend on the country comparison being made.

Note that this model only provides a summary framework for estimating relative country risk. In practice it will only reflect the intelligence that goes into the relative risk ratings. A thorough and rigorous analysis of all the factors that underlie even the limited number of 30 criteria in Table 14.4, in terms of both current and future investment conditions, is not easy. In some cases quantitative data are available, including from some of the agencies and sources listed above. For other criteria, such as political stability or the likely impact of corruption, there is no such thing as perfect information, and assumptions, estimates and some subjective guesswork are always necessary. However, the better the expertise, information and experience that can be leveraged to make such assessments, whether from inside or outside the firm, the more accurate the relative final scores are going to be.

What the model also helps decision-makers do is identify the kinds of risks they may be able to reduce, adapt to, prepare for or guard against prior to or following an investment. Knowing which sources of risk you can influence, and which you cannot, puts you in a better position to manage a market-entry strategy. Negotiating with government agencies, customs officials or local unions; establishing alliances with local recruitment agencies or banks; or generally developing networks of local contacts and

advisors can all help monitor and alleviate some of these risks and are essential.

In practice, a common problem is for managers to fail to consider the full range of country risks that might affect an investment or to make uninformed assumptions in their appraisal. A project team responsible for capital budgeting in an accounting or finance department of a firm may not know a great deal about different country conditions. Project investment models and financial scenarios may be transferred with a range of built-in assumptions that can hide additional costs or risks from the appraisal. For example, differences in labour rates are a key driver for the movement of manufacturing plants and for offshoring. Many companies build in the reduced labour cost, which makes savings and resulting profits look impressive, but assume similar levels of productivity and transactions costs for the new overseas operation. The additional costs and risks may become more obvious over time, with experience, and profit can quickly turn to loss. This has happened to some of the large numbers of companies that outsourced parts of their IT and back-office operations to India, for example.[4] So how can we build country risk analysis into our financial planning tools?

Accounting for country risk

International managers can incorporate elements of the above kinds of risk analysis into financial appraisal models when considering FDI. A five-year return on investment (ROI) or return on assets (ROA) model should take account of a range of risks as an input into financial estimates of costs and revenue. This enables a more realistic comparison between countries as locations for various kinds of investment. Although never perfect, because we have incomplete information about the past and present, and it is impossible to accurately forecast the future, this can still help decision-

makers build better estimations. They can develop a better understanding about the likely impact of certain events or changes on specific investment propositions; they can compare investment propositions across different country contexts; and they can revise estimates for investment returns on the basis of this kind of analysis.

Companies that try to incorporate risk estimation in financial appraisals tend to build on standard financial models at the project level. The most common work on the basis of net present value (NPV), ROI or internal rate of return (IRR) calculations, and these can incorporate country risks in a number of ways. A common approach is to increase the hurdle rate for ROI at the pre-project consideration stage, which will deselect the riskiest propositions. The hurdle rate is the set rate of financial return over a period of time that covers both project costs and the cost of the capital needed for the investment. Companies or business units will often have a set rate of return below which they will not invest. A simple rule of thumb would be to increase the rate of return in line with the additional risks associated with locating the investment in a particular country, compared to another.

Also common is to adjust the cash flows of the project to reflect the potential impact of a particular event on the value of the project. So, for example, if policy changes that will lead to an increase in tax rates, import duties or labour costs are likely, this risk needs to be built into the long-run calculation of the break-even point of an investment. There is a probability that costs will rise and net revenues will decline, so this can be built into a five- or six-year forecast for an investment. The term **adjusted present value (APV)** is sometimes used to denote an NPV that takes into account the riskiness of the project's expected future cash flows.

More sophisticated techniques for accounting for country risk have been developed. Some firms attempt to place specific probabilities on certain events taking place and calculate the direct cost implications for the project.

This approach works well as an extension of the above country risk assessment model, but again relies on accurate information and intelligence to derive realistic probabilities. If political analysts estimate that there is, say, a 20 per cent chance that the government of a particular developing country will change in the next three years, resulting in a radical change in policies towards foreign investors, this risk can be reflected in a higher hurdle rate for the APV and an alternative location for the investment might look more promising. This kind of approach is often termed *sensitivity analysis* and can be combined with formal *scenario analyses*. More sophisticated real-options analyses might attempt to calculate relative costs and benefits of, for example, closing a facility, moving it to another country, scaling down operations, or continuing in the face of a significant economic or political shock.

Active learning check

Review your answer to Active Learning Case question 2 and make any changes you like. Then compare your answer to the one below.

2 **What kinds of country risks have Nestlé and other MNEs faced when doing business in Nigeria?**

Companies like Nestlé experience the full range of legal/governmental and non-legal/extra-governmental risks at the macro and micro levels in Nigeria. Policies and laws for foreign investors change regularly for reasons that are often politically motivated. This can create higher costs, which affect all firms, or other disadvantages, such as import tax duties or export licensing costs, which can have a greater impact on MNEs. The threat of terrorist attacks is ever-present as is the impact of corruption in its various forms.

These techniques not only alert managers to relative sources of risk when comparing investment propositions, but also can help develop strategies to reduce risk. In the case of the developing country where the change of political party is likely to adversely affect foreign investors, this may lead to political lobbying by foreign firms with investments at risk. It also leads, unfortunately, to MNEs actively intervening in unethical ways in the national politics of smaller nations to secure their interests.

NEGOTIATION STRATEGIES

There are two key steps in developing effective negotiating strategies. First, MNE managers need to evaluate their own position and that of the other group(s) in order to determine how the interests of both can fit together. Second, they need to understand the 'modus operandi' of the other groups: who has the power to make what kinds of decisions and what negotiating style are they likely to adopt?

Earlier in this chapter we discussed how widespread deregulation and liberalisation were opening up emerging markets, like China and India, to foreign investors. Central and regional government agencies still maintain a strong control over these economies and the rules of engagement for foreign investors, so it is imperative that MNE managers understand: (1) their political, economic and social policy objectives; (2) their levers of power, the mechanisms by which they can influence the costs and benefits of doing business (taxes, tariffs, quotas, regulations on capital transfers, local input requirements, etc.); (3) the structures, networks and institutional agencies through which they operate (who has the power to influence what?); and (4) their negotiation style and tactics. These represent the 'whys and hows' of government intervention in market forces, and firms have to adapt to these to improve their chances of investment success.

Figure 14.3 depicts the interplay among: (1) the elements that attract multinational firms to a particular region, which have been discussed throughout this text (central column); (2) the strategic aims of MNEs; and (3) some general policy aims of governments. MNE objectives may or may not fit with government aims and this will affect the investment decision.

Taking this a step further, the most effective negotiation strategies are those that incorporate (1) the relevant risk criteria in Table 14.4 that can be influenced through negotiation, (2) the evolving government policy priorities, and (3) the appropriate government agencies, local organisations and key individuals who should be approached. This helps reduce the risk or increase the potential rewards from cross-border investments. If energy resources are important for a large-scale manufacturing facility, can local authorities guarantee energy supplies at a particular cost over a particular period in return for the plant being located in their region? If labour costs are an important factor, can these be fixed for a period of time through negotiations with local trade unions?

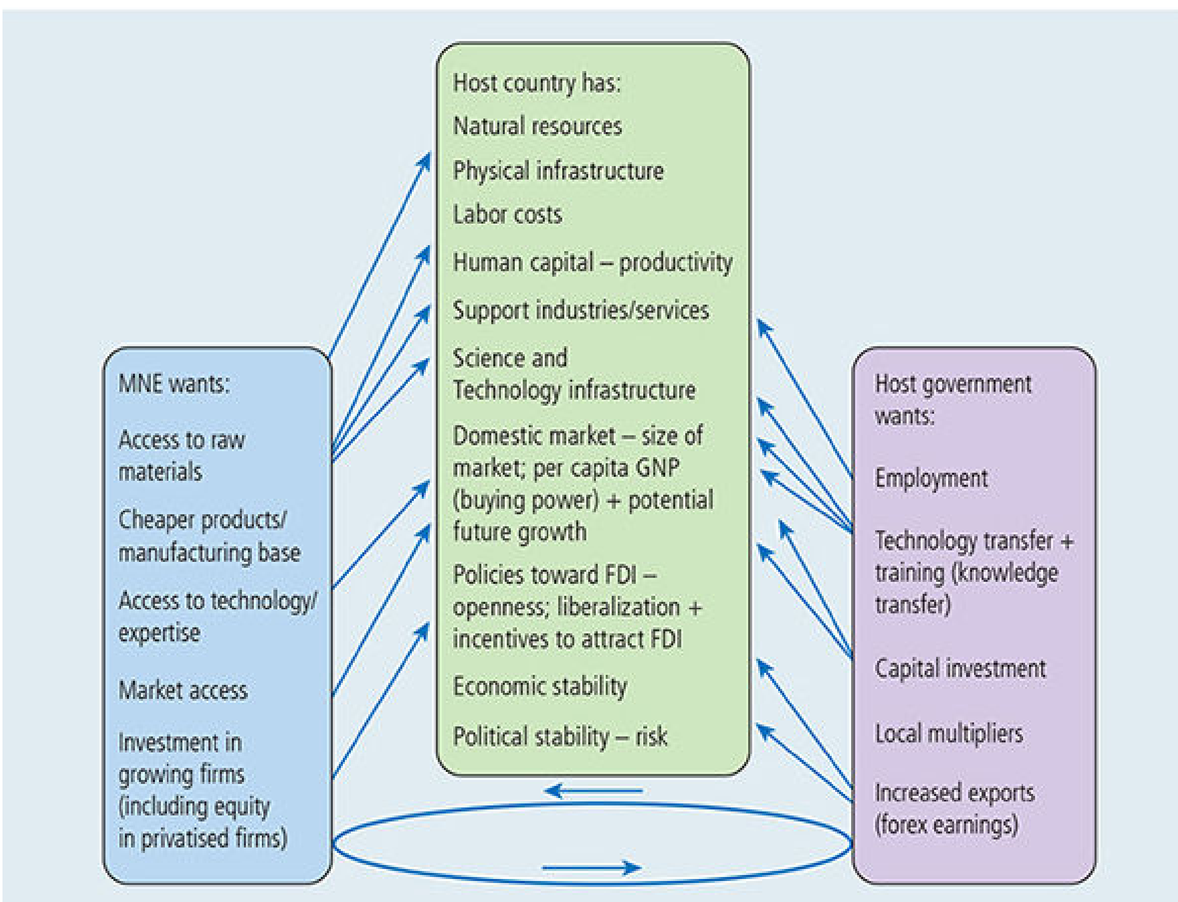

Figure 14.3 **FDI drivers: the strategic objectives of MNEs, host-country attractiveness, and host-government requirements**

Negotiations between MNEs and national governments or local organisations are a two-way bargaining process where each party has something the other wants. We can identify power resources or bargaining chips held by MNEs looking to invest globally on the one hand and by the governments of host countries on the other. Governments look for inflows of capital and technology, for large local employers, and for access, via MNEs, to overseas markets to boost exports and foreign exchange reserves. To get these they leverage their attractiveness, which may consist of large or growing domestic markets, natural resources, cheap or productive labour, and economic and political stability, to which they may add specific incentives, such as tax breaks or higher levels of foreign ownership or profit repatriation than normally allowed.

The bargaining strength of both firms and governments is limited by the degree of competition. If other MNEs offering similar levels of capital investment, employment or technology exist, the negotiating position of one MNE is weakened. If other regions offer cheaper labour, more economic or political stability, or better incentives to foreign investors, the negotiating position of the government is weakened.

The bargaining strengths for an MNE may come from its technology, products, services, managerial expertise and capital. For example, when General Motors sets up a new operation in Mexico, the company invests capital, uses modern technology to build the autos, and employs managerial expertise in getting the operation up and running. When the Hilton Corporation builds a new hotel in Germany, it invests capital, employs managerial expertise, and offers a variety of world-class hospitality services to the guests. MNEs also hire local personnel, stimulate the economy, and, in industries such as manufacturing, textiles and mining, help to generate exports for the country.

The bargaining strengths of the country will include such factors as large consumer markets, economic and political stability, sources of capital, tax breaks and an appropriate labour force. The United States, for example, offers all these strengths to MNEs. As a result, the bargaining position of foreign MNEs vis-à-vis the US government is diminished. This is in contrast to the situation faced by companies looking to set up operations in less developed countries, where the latter have a weak bargaining position because of their small consumer market, political instability and/or relative financial weakness.

Other parties involved in a negotiation will also have specific strengths. For example, in many cases a local partner knows the market and has conducted business there for years. This makes the partner valuable to the MNE. Other contributions of local partners can include capital, a well-trained workforce, factories or retail outlets for moving the goods to the customer and government contractors that can help to eliminate red tape.

Other parties to the transaction can include stockholders or other interest groups that monitor the company's operations. During the 1980s many MNEs stopped doing business in South Africa because of pressure from these investor groups. Companies involved in manufacturing war material, producing chemicals and building nuclear energy plants have also come under investor and social pressure. MNEs may also encounter complaints from partners in other joint ventures who feel that this latest investment will negatively affect their current venture.[5]

The membership of the WTO and various trading blocs around the world, particularly the EU and NAFTA, directly affect the degree to which national governments *can* intervene in trade and FDI. Governments in emerging markets and developing countries have more direct influence over the running of the economy and the rules and regulations governing trade and investment. However, once they have joined the WTO their use of

legislation governing foreign equity participation, profit repatriation, cross-border M&A and local content rules, as well as tax and investment incentives, becomes more restricted. At this stage, though, and in the foreseeable future for such countries, a higher level of direct control over the economy and foreign relations represents a significant influence over the ever-changing opportunities and risks for investors.

Finally, individual politicians and civil servants in less developed countries are able to use their own influence more effectively to block or to facilitate a particular MNE investment. This is partly due to the higher level of government control over the economy and individual businesses, but also because of the relative lack of legal or institutional recourse to challenge government actions. Couple this with the fact that salaries for government officials and bureaucrats in poorer countries tend to be very low and you get an insight into why corruption is so much more prevalent in developing countries, as discussed in the following section.

Behavioural characteristics of the participants in negotiations

When it comes to the actual process of cross-border negotiations there is a range of cultural, behavioural and tactical differences between groups that international managers need to understand if they are to negotiate effectively.

Cultural differences

Although the objective of the negotiation process may be universal (strike as good a deal as possible), the way in which the process is carried out will be greatly influenced by the cultural values and norms of the participants. Many of the following observations build on Chapter 5, which examines cultural differences between people from different countries around the world.

INTERNATIONAL BUSINESS STRATEGY IN ACTION

From riches to rags: the decline of the Venezuelan oil industry

In the 1960s Venezuela was considered a rich country, producing more than 10 per cent of the world's crude oil and the only non-Middle Eastern country included in the newly formed Organization of the Petroleum Exporting Countries (OPEC). It was the richest country in South America with GDP per capita of $954, far higher than its neighbours Brazil ($210) and Colombia ($245). Fast forward to 2019, Venezuela had two presidents in conflict and a humanitarian crisis leading to malnutrition, electrical blackouts and over 3.4 million refugees fleeing the country. This is a story of oil industry obliteration and political collapse that led to a country on the brink of collapse.

Through the 1970s, Venezuela attempted to diversify its economy, but failed as it was a product of its own success riding a spike in oil prices and enjoying years of steady democracy leading to an economic boom. The decline and eventual fall of Venezuela's oil industry can be essentially traced to its nationalisation in 1976 by President Carlos Andres Perez. The president banned foreign oil firms and established a state-run oil company Petróleos de Venezuela (PDVSA). With such an oil export dependency, Venezuela was hit hard by the mid-1980s global oil price collapse and led to a 50 per cent drop in production compared with pre-nationalisation. By the 1990s the government re-opened the country to international oil companies, with Chevron and ConocoPhillips moving back into the country. By the late 1990s however, another global oil price collapse led to widespread economic turmoil due to a failure to diversify its economy leading back to the 1970s.

In 1998 Hugo Chavez won the presidential election, aiming to expand PDVSA's profits which were integral to implementing his socialist agenda. The state-run PDVSA took further control of the oil market as Chavez placed royalties on foreign oil firms and mandated that the company would lead all new oil explorations and production. Discontent by the PDVSA worker's union rose and came to a climax in 2002 as workers went on strike, oil production fell from 3 million barrels to 200,000 per day and in the months following Chavez fired 18,000 workers. This had significant

knock-on effects and led to 25,000 additional workers leaving the company in 2017, leading to a skilled worker shortage.

Despite these losses, between 2002 and 2008 Venezuela once again rode high oil prices with oil prices peaking at $150 a barrel and making the country over $60 billion. This soon came crashing down in the summer of 2014, when Nicolás Maduro succeeded Chavez and oil prices crashed from $100 per barrel to less than $30 per barrel by 2015. The Venezuelan economy was completely dependent on oil revenue, 95 per cent of exports earnings came from oil and the 2015 crisis led to a GDP decline of 6 per cent and rapid rise in inflation. The situation continued to worsen, with widespread food and medical shortages leading to a humanitarian crisis in 2017–18. Venezuela's economy contracted by 47 per cent, twice that of Greece in the Euro crisis, with 2018 inflation at 80,000 per cent. This hyperinflation will soon reach levels worse than Zimbabwe in the 1990s and Ukraine after the collapse of the Soviet Union.

Politically, Venezuela was in turmoil after Maduro was re-elected in May 2018. There were questions about legitimacy from the global community and in response Juan Guaido was announced president as the leader of the National Assembly of Venezuela. The two remained in deadlock and with major global powers siding with Guaido and condemning Maduro US President Trump stated they would not rule out military action. Venezuela reached a 28-year low in oil exports in 2019. Despite being the home of the world's largest crude oil reserves the industry slumped due to political instability and mismanagement. Venezuela seemed to be impaired by long-term political, economic and social uncertainty, marking the country as too-risky for most international investors.

Sources: Foreign Policy.com (2019) https://foreignpolicy.com/2018/07/16/how-venezuela-struck-it-poor-oil-energy-chavez/; *The World Bank* (2019) https://data.worldbank.org/indicator/NY.GDP.PCAP.CD?end=1960&locations=BR-CO-VE-US&start=1960&view=bar; TIS (2019) https://www.theintlscholar.com/periodical/from-riches-to-rags-venezuelas-downward-spiral; The UN, (2019) https://news.un.org/en/story/2019/02/1033361; *Washington Post* (2019) https://www.washingtonpost.com/business/2019/02/01/venezuela-is-biggest-economic-disaster-modern-history/?noredirect=on&utm_term=.24e611fc037.

Commenting on the difference between Arab and US negotiators, one group of researchers noted:

> [Arabs] treat deadlines as only general guidelines for wrapping up negotiations. They tend to open negotiations with an extreme initial position. However, the Arabs believe strongly in making concessions, they do so throughout the bargaining process, and they almost always reciprocate an opponent's concessions. They also seek to build a long-term relationship with their bargaining partners. For these reasons, Americans typically find it easier to negotiate with Arabs than with representatives from many other regions of the world.

✔ Active learning check

Review your answer to Active Learning Case question 3 and make any changes you like. Then compare your answer to the one below.

3 *What are the pros and cons of MNE investment for Nigeria as a nation?*

Nigeria benefits from FDI worth billions of US dollars each year. About half of it comes from Europe and much of it goes into the gas and oil sectors. These investments boost imports and exports and help the country develop its local industry. They also create employment and a so-called regional 'multiplier effect' by stimulating growth in other businesses. These include suppliers and contractors that sell to foreign firms in the country, but there are also indirect effects on retailers, restaurants, cinemas and other consumer services from the additional disposable income created by the growing numbers of employees. Technology transfer and training also takes place, enabling local firms to improve their production and innovation capabilities. Finally, Nestlé and other MNEs advertise the support they provide for local charities, education foundations and poverty-alleviation projects in the towns and villages where they manage their operations.

On the downside, open markets that encourage inward FDI can create 'unfair' competition when large and powerful MNEs force smaller local firms out of the market. Some degree of protection for 'infant industry' development is advocated by some policy-makers so long as it targets specific sectors for growth. More critical observers argue that the repatriated profits of MNEs represent a form of exploitation. Their view is that added value and wealth created from oil and other local natural resources should be reinvested in the domestic economy.

One of the major differences is the amount of authority that the negotiator has to approve an agreement. In some societies, such as the United States and UK, negotiators are given authority to make deals or at least to express agreement on the basic arrangement that is being negotiated. This approach works well when doing business with many Western firms, as well as with

Chinese negotiators. However, it is often of limited value when dealing with people from other cultures. In fact, the other parties may not have the authority to give the go-ahead on anything. For example, Japanese and Russian negotiators are often lower-level personnel who are not authorised to approve agreements. This can be frustrating to Americans who feel that they are wasting their time. The lack of face-to-face interaction with those who will be making the final decision can be unsettling. On the other hand, many foreign negotiators use this ploy because they have learned that it often leads to greater concessions from US business people, who become anxious to sign a deal and thus are more flexible on terms.

INTERNATIONAL BUSINESS STRATEGY IN ACTION

Intel effect

Established in 1968, the Intel Corporation, also known as Intel, is an American multinational technology organisation headquartered in Santa Clara, California. In 2018, Intel acquired $70.8 billion in revenue and employed a workforce of 107,400 individuals around the world. The American giant holds global market dominance as a high-value semiconductor computer chip manufacturer.

In 1996 Intel announced that it would be opening a $300 million test plant in Costa Rica. Intel not only planned to open a single test plant, but wanted to open a campus that would accommodate four plants with the potential of employing 3,500 employees over time for a total investment of $500 million. Intel began to work in Costa Rica in 1997 with an assembly and test plant, and by 2013 it had expanded its activities to make it one of the largest R&D centres in the country. In 2013, Intel employed over 3,000 employees covering design, prototyping, testing and validity of software solutions.

The presence of Intel in Costa Rica came with positive effects on the economy as it provided jobs and support for local industries. Furthermore, Intel was identified as a 'catalyst' within Costa Rica when attracting FDI. In 2014 Intel was certified as 'Essential Costa Rica', which was the nation's brand license. However, in the very same year, reacting to a very difficult competitive environment, Intel decided to close its microprocessor assembly plant in Costa Rica. This decision to leave Costa Rica was likely to be triggered more by its lack of success to compete successfully in the global market than by any particular problem with its local operations or the attractiveness of the country as a high-technology centre. But it had significant effects on the local economy.

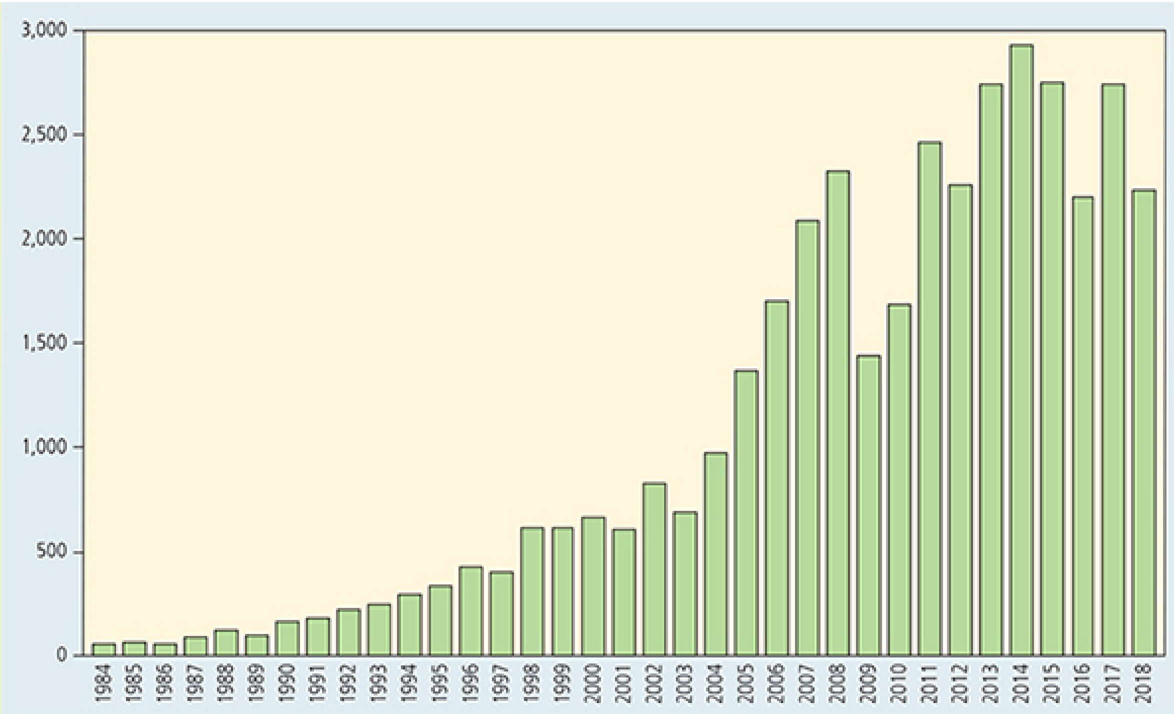

Figure 14.4 **FDI flows in Costa Rica, 1984–2004**

Source: Banco Central de Costa Rica.

Intel had failed to capitalise on providing chipsets for the smartphone industry, where rivals such as Qualcomm, NVidia and Texas Instruments dominated. The closure was inevitably felt across the economy, as Intel operations in Costa Rica alone were valued at approximately $2 billion per annum. Furthermore, Intel accounted for 20 per cent of the country's exports, which was over twice the size of the nation's traditional exports of bananas and coffee. It has been reported that from 2000 to 2012 Intel accounted for 11 per cent of net FDI. Even though Intel hired 200 employees in 2014 in its engineering and global services department in Costa Rica, this would clearly not fully compensate for the closure of the assembly plant. Figures 14.4 and 14.5 highlight Costa Rica's boom in terms of FDI flows and exports and imports following Intel's arrival.

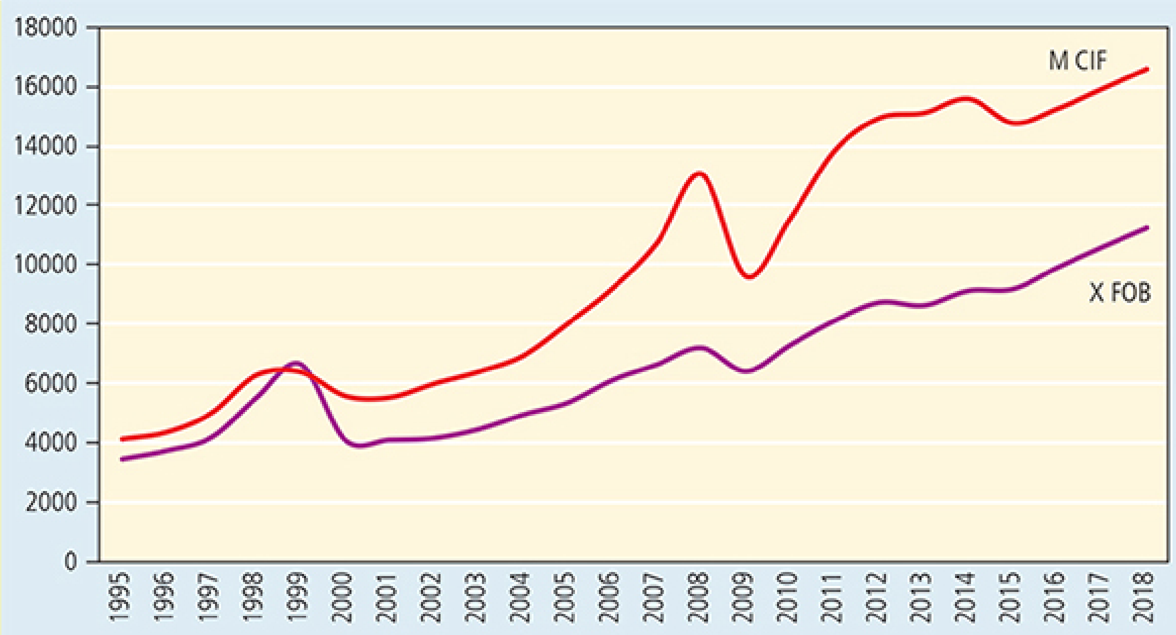

Figure 14.5 **Costa Rica: imports and exports, 1995–2003**

Source: Banco Central de Costa Rica, based on the costums declarations.

It is difficult to assess how Intel's exit affected Costa Rica's ability to attract inward investment. But the firm left over 1,500 employees who have acquired key skills as engineers or technicians, and they could be viewed as a prize asset for any organisation seeking to expand its business to or within Costa Rica. In addition, it has often been ignored that the service industry also plays a crucial part in Costa Rica's exports. Even though tourism is the largest industry, IT services are the second largest, contributing $1.9 billion towards the economy. It is also important to acknowledge the large volume of profit outflows from foreign organisations in Costa Rica, which reached $800 million in 2013. With the dramatic downsizing and lower profits expected from Intel, Costa Rica may benefit from an improvement in income deficit levels.

Acknowledging the fact that Intel was a crucial source of GDP growth, it is still difficult to decide whether Costa Rica will face serious long-term difficulties. Costa Rica publishes a monthly economic activity index (IMAE), and during 1997–2004, including the high-technology sector, the economy grew by an average of 5 per cent. In contrast, within the same time period, excluding the high-technology manufacturing industry, the economy averaged growth of 4.2 per cent.- Furthermore, the high-technology industry was recorded as being more volatile than the rest of the

economy, as it experienced large growth trends and large non-growth trends which significantly affected the rest of the economy.

One argument is that Costa Rica's high-technology industry, dominated by foreign firms, has created a dual economy with few positive spillovers to the rest of the economy. This dual economy has increased inequality levels, with foreign companies out-competing any emerging local firms but also failing to support the development of domestic suppliers and subcontractors. Backward linkages have failed to evolve in the short timescale over which this high-technology microchip production sector has developed.

A new hope

More recently there are signs of accelerated economic growth for Costa Rica, as the government spreads the net more widely to attract other foreign firms into the country. In 2015 President Luis Guillermo Solis ended a ten-day tour of four US cities with promises of investment from organisations such as Dole Food Co. and Bridgestone Corporation, to help reduce unemployment levels which had by then risen to 10.1 per cent. After experiencing difficulties following the closure of Intel, it seems that Costa Rica is learning from its narrow focus on the high-technology sector and seeking to benefit from other kinds of inward investment. Intel supports Costa Rica's rise up the global value Chain, as it generates approximately 60 per cent of the nation's research and development exports, and represents 20 per cent of Costa Rica's total sales. However, the future of Intel in Costa Rica is uncertain as the tech giant announced in 2019 that they would be laying off some of the workers in Costa Rica, but they have still not provided exact details about the cutbacks.

Sources: www.intel.com; R. Aguilera, 'Costa Rica: life after Intel', *The World Post*, 1 July 1014, accessed from http://www.huffingtonpost.com/rodrigo-aguilera/costa-rica-life-after-int_b_5246788.html; S. Jose, 'Intel outside', *The Economist*, 19 April 2014; E. Martin and M. McDonald, 'Costa Rica sees "Intel effect" ending as GDP poised for pickup', *Bloomberg*, 1 June 2015; *The Impact of Intel in Costa Rica: Nine Years after the Decision to Invest*, World Bank Group, 2006; Intel Annual Report 2018; https://www.intel.com/content/www/us/en/corporate-

responsibility/intel-in-costa-rica.html; https://qcostarica.com/intel-announcement-of-layoffs-in-costa-rica-surprised-president-alvarado/.

Another cultural difference in negotiating style is the objective of the negotiators. As the typologies in Chapter 5 show, American, German and British managers, for example, tend to be very practical and to focus on short-term results. Negotiators from the Far East tend to move more slowly, like to get to know the other party, and have a more long-run focus. Gift giving, social custom and certain rituals can play an important part in negotiations and are part of the initial process of developing trust and mutual respect.

Language is also a key factor. When negotiators do not speak the same language and must use interpreters, there are more chances for a misinterpretation or misunderstanding to occur. This problem also exists in written communications. Schermerhorn, for example, has found that, when documents are translated from one language to another and then translated back to check for accuracy, there are interpretation problems.[6] The original translation appears to convey the desired information, but, when another person is called in to translate the document back into the original language, some parts of it are different from that initially intended.

A related cultural problem is the use of written documents. In some countries a written document is used as a basis for establishing what is to be done. As a result, the document is detailed and factual. In Germany it will be precise and technical; in the United States it will be legalistic. In other countries, however, a written document is viewed as the basis for a general agreement and the parties then negotiate the implementation as they go along. Chinese and other Far East negotiators often view detailed contracts

as a sign of distrust and believe a more open-ended agreement should be used.

Acceptance zones

Each party to a negotiation will have an **acceptance zone** or an area within which it is willing to negotiate. For example, if AB InBev (one of the world's largest brewing and beer brand companies, which grew largely through acquisitions) wants to buy a brewery anywhere in the world the MNE will determine three prices: the highest price it is willing to pay, the price it would like to pay and the offer at which it will begin the bargaining. For purposes of illustration, assume that it is willing to pay up to $25 million for the company but hopes to make the acquisition for $23 million and intends to start the negotiation at $20 million.

Will AB InBev be successful? This depends on the acceptance zone of the target firm. If the company will not sell for less than $27.5 million, there will be no deal because the buyer's maximum offer is less than the seller's minimum acceptance. However, assume that the firm will not sell for less than $21 million, would like to get $24 million, and intends to start the negotiation at $28 million. In this case, the two sides should be able to strike a deal, since they have overlapping zones of acceptance, as illustrated in Figure 14.6.

Notice from Figure 14.6 that, when the acceptance zones of the two parties overlap, there is common ground for negotiating. Additionally, keep in mind that, if the zones do not overlap, negotiations will not always end in a stalemate. After listening to each other, the parties may agree to change their respective bids and offers, adjust the acceptance zones, and end up with common negotiating ground.

In the case of Figure 14.6 the two parties would eventually negotiate within a range of $21 million (the least amount the seller will take) and $25

million (the most the buyer will pay). It is not possible to say what the final price will be because this will depend on how willing each side is to concede ground to the other. However, whatever the final price, the seller is going to get at least the desired minimum and the buyer will not pay more than the established maximum.

Bargaining tactics

Negotiators use a range of bargaining tactics, including promises, threats, rewards, commitments and the use of self-disclosure, in their drive for a better deal. Some of these are also linked to different cultural characteristics, as shown in Table 14.5. Keeping silent is a standard Japanese practice when negotiating with each other as well as with foreigners. Table 14.5 shows that each group of Japanese, American and Brazilian negotiators has a series of behaviours that make it different from the other two. For example, the Japanese like to make recommendations, the Americans make wide use of promises and the Brazilians rely heavily on self-disclosure.

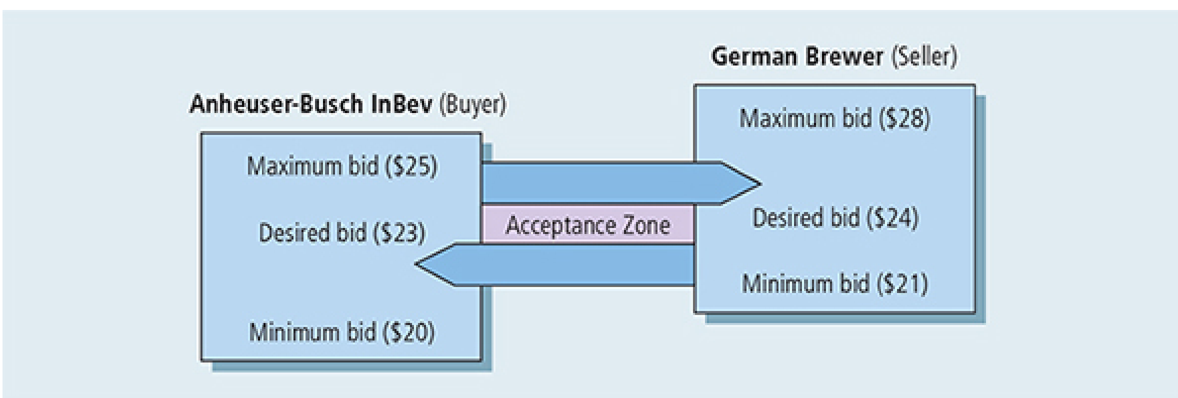

Figure 14.6 Zones of acceptance in the negotiating process

Table 14.5 Twelve examples of the differences in verbal behaviours among Japanese, American and Brazilian negotiators

Behaviour (description)	Number of times behaviour was used in a 30-minute negotiating session by members of each group: Japanese	American	Brazilian
1 Making promises	7	8	3
2 Making threats	4	4	2
3 Making recommendations	7	4	5
4 Giving warnings	2	1	1
5 Offering rewards	1	2	2
6 Making commitments	15	13	8
7 Asking questions	20	20	22
8 Giving commands	8	6	14
9 Revealing personal information about oneself	34	36	39
10 Making a first offer	61.5	57.3	75.2
11 Granting initial concessions	6.5	7.1	9.4
12 Using the word 'no'	5.7	9.0	83.4

Source: Adapted from John L. Graham, 'The influence of culture on the process of business negotiations: an exploratory study', *Journal of International Business Studies* (spring 1985), p. 88, Palgrave Macmillan.

These behaviours and tactics are often used in international negotiations. Effective negotiators learn how to use them and how to counteract their use by the opposition. Some examples are provided in the next section.

Transparency and corruption: politically sensitive political risk

One of the most difficult aspects of foreign business for international managers is how to cope with corruption. A very large number of firms engage in bribery of various kinds, but the ethical issues are not straightforward. In many cases they argue that to opt out would simply mean they lose out to less ethically minded competitors. In other cases it is genuinely difficult to know whether such practices are simply the accepted local rules of the game. In the UK an extra payment to rail companies buys you a better seat on the train in a less crowded compartment. This is called 'First Class'. In India an extra payment may get you onto a train that is already overbooked (or that you are told is overbooked). The only difference

is that the payment will go straight into the ticket collector's pocket, rather than the railroad company. However, in many places it is accepted that workers in national industries or officials in government agencies will top up their incomes by offering these kinds of 'discretionary services'.

There are very different levels of corruption, from the small scale to the very large scale. Our Indian ticket collector may make a few extra rupees each month from small-scale bribes. Various presidents, including Fujimori (Peru), Aleman (Nicaragua), Ben Ali (Tunisia) Marcos (Philippines) and Mobuto (Zaire/DRC) have embezzled $100 millions and in some cases billions during their time in power. Suharto of Indonesia tops many lists with an estimated $30 billion in stolen funds in his tenure, in a country with (at that time) an average GDP per capita (an indication of average annual salaries) of $695. But MNEs are often involved as the party responsible for bribing senior officials. Odebrecht and its petrochemical subsidiary, Braskem in Brazil, for example, admitted bribery to the tune of $788m and agreed a record fine of over $3.3 billion.

Governments, particularly those in previously centrally planned economies, are directly responsible for a large volume of purchasing. The volume of government expenditure on public procurement in China has grown immensely in the past decade, as its economy and the need for large-scale infrastructure projects grew. Chinese officials' overseas trips, the procurement and maintenance of government cars, and the fees for official receptions also increased significantly, pushing the central government to limit corrupt practices through policies such as the Public Procurement Act. But such activities are not confined to emerging and developing countries. Bid rigging is widespread in Japan, particularly in the construction industry. The Act on Elimination and Prevention of Involvement in Bid Rigging was an attempt by the Japanese government to curb such practices, which involve collusion among powerful *keiretsu*, industry bodies and government

agencies. The amount lost due to bribery in government procurement globally is thought to be at least $500 billion.

The Berlin-based organisation Transparency International (TI) produces a number of reports each year, of which the best known is the Corruption Perceptions Index (CPI). The CPI has promoted research into, and more open discussion of, the causes and consequences of corruption. **Corruption** is defined by TI as 'the misuse of public power for private benefit', and each year TI has evolved the methodology to improve consensus and acceptance of the metrics that underlie the country rankings.

The extent of corruption is a measure of the *frequency* and *value* of corrupt payments and the resulting obstacle imposed on businesses. A composite index from different polls and surveys from independent institutions, including the World Economic Forum, the World Business Environment Survey of the World Bank, the Institute of Management Development (in Lausanne), PricewaterhouseCoopers, the Economist Intelligence Unit, and Gallup International on behalf of Transparency International, are used in the CPI. The 2018 survey shows Denmark, New Zealand and Finland as the least corrupt economies, Germany and the UK are joint 11th (out of 180 countries), Japan 18th, France 21st, the United States 22nd, Spain 41st, Italy 53rd, India 78th, China 87th, Brazil 105th, Russia 138th and the most corrupt countries as North Korea 176th, South Sudan 178th and Somalia 180th.

Another report is the *Bribe Payers Index* (BPI), which measures the 'propensity of companies from 30 leading exporting countries to bribe abroad'. It is based on the responses of more than 11,000 business people across 125 countries, polled in the World Economic Forum's Executive Survey. Although multinational firms from advanced countries usually rank high in the index, they still regularly pay bribes. Companies from emerging economies, including the BRIC countries, tend to rank among the worst.

Despite high-profile campaigns to reduce the amount of local corruption in these countries, their firms actively bribe when abroad.

Other reports by TI examine other elements of corruption, including the most prominent offenders in specific countries, usefully comparing, for example, the judiciary, customs, police, local administrators, registry and permit officials, tax officials and traffic police in various countries. Case studies and intra- or inter-regional comparisons also make up much of TI's analysis.[7]

The global corruption report by TI shows a clear correlation between corruption and income. Poorer countries (like Bangladesh) tend to have the highest incidence of corruption. In low-income, developing and emerging markets, transparency is also more of a problem. **Transparency** reflects the *clarity* and *consistency* of policies and legislation applied in the governance of businesses and is strongly associated with corruption. There is considerable debate about the relative levels of corruption and transparency prevalent in developing and advanced countries. The latter do tend to have more governance checks and balances, and arguably more freedom of the press and leeway for interest groups to reveal and oppose corrupt practices and transparency problems.

There is, however, a socio-cultural dimension to such issues, and in some countries certain established, recognised and accepted business practices are considered to be the 'local rules of the game' that should simply be respected and adapted to, rather than criticised as non-Western. Again, China provides a useful illustration. One of the key obligations for China as it joins a growing range of international organisations (such as the WTO) and legal treaties is to improve its transparency. In the past, import duties have been found to vary between 10 and 20 per cent for the same product because customs officers across the country do not have a standard definition or system for categorising product types. This has not just led to MNE

managers and local importers having to engage in extended discussions with local officials regarding product categorisation, but significantly increased the incentive and opportunity for bribery.

Government clean-up campaigns in China have focused on the standardisation of rules governing both domestic and foreign businesses. The licensing procedures for both have tended to be unregulated and very much at the discretion of local officials, who are said frequently to abuse the yearly check-up system (*Nianjin*) to earn additional fees before approving licenses. However, foreign firms without the necessary *guanxi* (informal, reciprocal obligation networks) connections are subject to these and other additional charges. The more bizarre include the ‘spiritual civilisation fee’ and a ‘wall-cleaning fee’ that can run into thousands of US dollars.

STRATEGIC MANAGEMENT AND POLITICAL RISK

MNEs take many steps to ensure that their strategies do not go awry because of unexpected developments. One of the most beneficial steps is the use of integrative and protective/defensive techniques.

Use of integrative and protective/defensive techniques

There are a variety of stratagems that MNEs employ in reducing risk. Some are collectively known as **integrative techniques**, which are designed to help the MNE become a part of the host country's infrastructure. The objective of an integrative technique is to help the company blend into the environment and to become less noticeable as a 'foreign' firm. One of the simplest ways is to use a name that is not identified with an overseas company and, if an acquisition is made, keep the old name in place. For example, Bridgestone is a Japanese tire company, but no one would know this based on the name of the company. Additionally, Bridgestone owns Firestone Tire and Rubber, but few Americans are aware of this fact. Similarly, Hoechst of Germany owns the Celanese Company, and most people do not know this. Nor do many people realise that almost 25 per cent of the banks in California are Japanese owned; their names provide no clues to their real owners. This tactic deflects public attention and concern that US assets are being swallowed up by overseas investors.

Another common integrative technique is to develop good relations with the host government and other political groups and to produce as much of the product as possible locally. In turn the MNE will hire and promote local personnel and use them to run a large portion of the operations. This strategy

endears the company to the government and, if any action is taken against foreign firms, these firms are likely to be spared.

Protective and defensive techniques are strategies that are designed to discourage a host country from interfering in multinational operations. In contrast to integrative techniques, protective and defensive measures are aimed at fostering *non-integration* of the MNE into the local environment. A good example is conducting research and development (R&D) at other geographic locales and importing this knowledge as needed. Should the government suddenly decide to seize the firm's facilities, the company's R&D base would not be threatened.

Another protective and defensive technique is to limit the role of the local personnel to those operations that are not vital to the running of the facility. So, if the government decides to take over the operation, the host-country personnel will not be able to handle things efficiently. Those with the requisite knowledge and training are overseas personnel who are sent on site by the multinational.

A third technique is to raise as much capital as possible from the host country and local banks. When this happens, the government is reluctant to interfere in operations because this may threaten its own investment and that of the home-country banks. In a manner of speaking, this strategy co-opts the government and brings it onto the MNE's team. Any strike against the multinational is a blow against the host country.

A fourth technique is to diversify production among a number of countries. In this way, if the government seizes the MNE's facilities, only one area of production is disrupted. The company can then reallocate production and get back on stream in short order.

Combination strategies

MNEs often use a combination of integration and protective/defensive techniques to reduce and manage their political risk. Figure 14.7 provides an example of how companies can do this. In the case of the low-technology manufacturing firm (no. 1 in Figure 14.7), the only way to employ a protective/defensive strategy is to raise capital locally. As a result, this firm will work to integrate itself into the country and to act very much like a local firm.

An international air carrier (no. 2 in Figure 14.7) will use an integrative strategy by setting up local operations and by hiring people to staff the facilities, to maintain the aircraft and to handle arrivals and departures. The airline will also help to generate money for the country by bringing in tourists and business people. At the same time, the company will seldom have more than a small percentage of its aircraft in this locale on any one day. Additionally, the pilots will often come from other countries and be highly skilled individuals, and the top management team will be operating out of headquarters in the home country. So, while the air carrier will take some steps to accommodate the country, it will also be well positioned should the country decide to seize its aircraft or to increase taxes or airport fees. Moreover, aside from facilities at the airport, the company will usually have no other fixed assets except for the aircraft. Therefore, any crackdown on the airline might result in retaliatory action by other airlines, which would refuse to fly into the country. Such action could seriously hamper the country's economic growth. Consequently, a strategy that provides for the intermediate use of both integrative and protective/defensive techniques often works extremely well.

A high-technology R&D firm (no. 3 in Figure 14.7) will not put much emphasis on integrative techniques because it does not want to become integrated into the local economy. The firm may be situated where it is because the company finds that it is easier to recruit top talent to live in that

region. Or other competitors may be headquartered there, and the company finds that it is easier to keep tabs on these firms by situating nearby. So, while the company may hire local people to staff basic operations, personnel from other countries who live locally will handle all the R&D and other sophisticated functions. If the firm should hire local people for some of these R&D positions, the company will work to keep them loyal to the firm and not to the country. Thus, if there is an attempt to seize the firm's R&D facilities, the loss will be minimised.

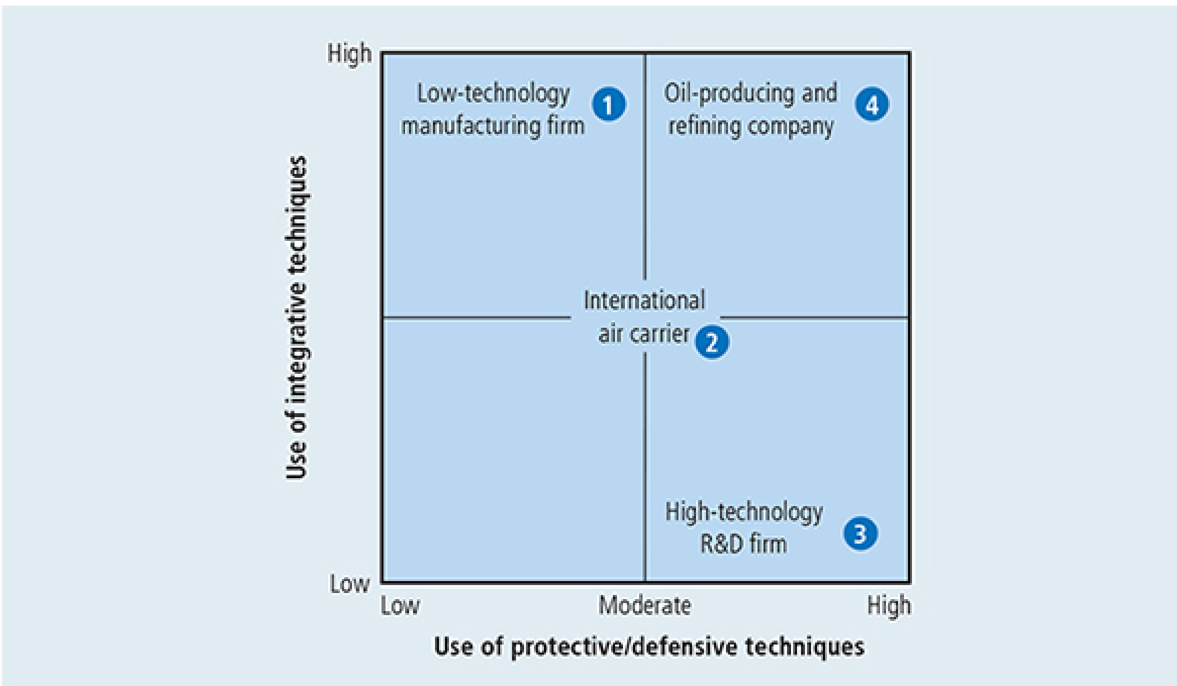

Figure 14.7 Select examples of the use of integrative and protective/defensive techniques

In the case of an oil-producing and refining company (no. 4 in Figure 14.7), the firm is likely to make strong use of both integrative and protective/defensive techniques. The company will need to get on well with the government, since it is tapping the country's natural resources. There is likely to be a great deal of hiring of local personnel for routine jobs. The firm will also work hard to generate as much revenue as possible, since the government is unlikely to interfere with the operations of a revenue-

producing firm. At the same time, the MNE will maintain control of the more sophisticated jobs so that these cannot be carried out by anyone else. If the company were to be taken over, local workers would be unlikely to know how to operate the machinery and equipment efficiently.

Identifying sources of potential risk and assessing the possible impact on foreign investments of all kinds is difficult to do. Emerging and developing countries generally represent riskier markets, as well as potentially more rewarding markets for MNEs. Their rapid rate of growth, strongly interventionist policies, less mature government institutions and evolving governance systems all create additional uncertainties for foreign investors. These add to the existing complexities of trying to cope with different economic, social and cultural ways of doing things. International managers looking to invest in these countries need to develop an in-depth understanding of the ever-changing official, formal rules and regulations governing different kinds of investment. In addition to the country risk analysis techniques introduced here, there is no substitute for direct experience. Only by visiting and learning about the geographic, socio-cultural, economic and political context in which business takes place can managers develop a qualitative, tacit understanding about the official, formal and the unofficial, informal local rules of the game.

✔ Active learning check

Review your answer to Active Learning Case question 4 and make any changes you like. Then compare your answer to the one below.

4 What are the lessons for other firms looking to invest in developing countries like Nigeria?

One overriding lesson from Nestlé's experience in Nigeria is that understanding economic and political risks and their underlying sources can significantly increase your chances of making a successful investment in an uncertain emerging market. The company has taken the time and made the effort to understand what the risks are and reduced some of the potential impacts by adapting to the local business environment. It hires a large number of local nationals in senior management positions to guide the local subsidiaries, and provides training and education to build understanding in its local workforce.

A second lesson is not to make assumptions based on your understanding of operating in other economies. Any manager who fails to build in the additional costs that arise from poor energy infrastructures or transport systems, the length of time and expense of importing components or the possible additional costs of thefts, will fail to invest wisely. Accurate estimates of the probable profit and loss scenarios of any investment project must be based on current costs and likely future conditions encompassing all of these risks and uncertainties.

Companies like Nestlé are also highly sensitive to local politics, investing in strong relationships with key agencies to monitor developments and be ready to respond to the threats and opportunities that stem from shifts in government policy.

We must remember that Nestlé is a very large MNE, with the global scale and the financial muscle to invest to fill gaps in local infrastructure, resist excessive demands from corrupt officials and cope with the turbulence and uncertainties of country markets like Nigeria. Most international firms do not have this level of assets, resilience or experience and this can make the task of successfully investing in somewhere like Nigeria even harder and far riskier.

KEY POINTS

1 Country risk analysis examines the chances of non-market events (political, social and economic) causing financial, strategic or personnel losses to a firm following FDI in a specific country market.

2 A PEST analysis provides a starting point for examining and comparing political, economic, socio-cultural and technological conditions in countries that present investment opportunities. Add depth and foresight to make PEST a little more rigorous.

3 Political risk is the probability that political forces will negatively affect an MNE's profit or impede the attainment of other critical business objectives. This risk can be examined in terms of macro and micro factors. A macro political risk is one that affects foreign enterprises in the same general way. A micro political risk is one that affects selected sectors of the economy or specific foreign businesses.

4 General trends towards liberalisation and deregulation have opened up a range of emerging markets to FDI, but governments maintain a strong level of control over the economy and the activities of foreign firms. Their ever-changing policies are a source of both new opportunities and risk.

5 There are a number of sources of political risk. Among others, these include the political philosophy of the government in power, changing economic conditions, rising nationalism, social unrest, terrorism, the vested interests of local business groups and newly created international alliances.

6 There are numerous sources of information on political risk and global rankings of various kinds showing how countries compare. Online resources provide a quick and convenient way of starting a country risk analysis.

7 When assessing risk vulnerability at the project level, quantitative and qualitative information needs to be combined in an analysis of both the investment proposition and the country conditions. The Weighted Country Risk Assessment Model can provide a framework for this. Information gaps and uncertainty will always remain, but the process can improve FDI decision making.

8 Country risk analyses can be incorporated into financial forecasts to produce revised NPV, ROI, or IRR calculations. The adjusted present value (APV) takes into account country risk estimates.

9 Understanding the policy objectives, policy tools, institutional structures and networks, and negotiating tactics of government agencies will help foreign managers negotiate better local conditions for FDI.

10 Power resources are the bargaining chips used by companies and governments in investment negotiations.

11 Corruption is defined by Transparency International as 'the misuse of public power for private benefit'. It can be difficult to distinguish between corrupt practices and local rules of the game that stem from differences in local market structures and business cultures.

12 There are three key steps in developing effective negotiating strategies. First, the MNE evaluates its own position and that of the other parties to the negotiation. Second, the firm examines the behavioural characteristics of the other parties in order to better understand their style of negotiation. Third, the MNE uses this information to hammer

out an agreement that is acceptable to both sides. Identifying the acceptance zone of the other party is an important step.

13 MNEs tend to use a combination of integrative and protective/defensive techniques in minimising political risk.

Key terms

- **country risk analysis**
- **PEST framework**
- **political risk**
- **macro political risk**
- **expropriation**
- **indigenisation laws**
- **micro political risk**
- **Weighted Country Risk Assessment Model**
- **adjusted present value (APV)**
- **acceptance zone**
- **corruption**
- **transparency**
- **integrative techniques**
- **protective and defensive techniques**

REVIEW AND DISCUSSION QUESTIONS

1. How can a country risk analysis help an international manager making decisions about which countries to invest in?
2. How can we make a simple PEST analysis more robust, accurate and useful?
3. What is meant by the term *political risk*? Is there political risk in every country of the world? Explain.
4. Show, with an example, how the process of deregulation and liberalisation is opening up opportunities for foreign investment in emerging markets.
5. How does macro political risk differ from micro political risk? Compare and contrast the two.
6. What are some factors that help to determine the degree of micro political risk? Identify and describe three of them.
7. What resources are available online for comparing political risk in two or more countries? Give two examples and say how their measures and rankings differ.
8. What difficulties would a manager face in compiling an accurate Weighted Risk Assessment Model for two emerging market countries?
9. What is an adjusted present value calculation? Give examples of the kinds of country risks that could be incorporated into an APV calculated for a manufacturing investment in a less developed country.
10. When predicting political risk, why will an MNE be interested in examining the economic development agenda and policies of the government?
11. Choose a well-known MNE and describe the kinds of power resources or bargaining chips it could use in FDI negotiations with a country government.
12. Why does corruption tend to be more prevalent in poorer countries?
13. Describe one method for comparing the levels of corruption to be expected in two different countries.

14 Why is improving transparency important for investors and for local populations in less developed countries?

15 Why will an MNE be interested in the behavioural characteristics of the participants in a negotiation? How can such information help to improve its negotiating position?

16 In a negotiation, why would an MNE be interested in the acceptance zone of the other party?

17 What are some bargaining tactics that are used in international negotiating? Identify and describe three of them.

18 How do MNEs use integrative techniques in order to reduce their political risk? Describe an example.

19 How do MNEs use protective/defensive techniques in order to reduce their political risk? Describe an example.

REAL CASE

Huawei accused of spying

Founded in 1987 in Shenzhen, China, in just 30 years Huawei has grown to become a leading global information and communications technology (ICT) organisation that provides consumers with competitive ICT solutions, products and services. Operating in over 170 countries and serving over one-third of the world's population, the technology multinational employed 180,000 individuals in 2017. The growing dominance of this firm is further demonstrated by the fact that its revenue more than doubled from 2013 to 2017, reaching an impressive $92.549 billion in 2017 (Figure 14.8).

Although Huawei provide a range of ICT products and services, the firm is perhaps most well-known for its smartphones which have challenged Apple and Samsung's dominance in the global industry. In fact, Counterpoint Research found that in 2018, Huawei's global sales exceeded those of Apple, which places the firm as the second largest in the industry. This is pretty impressive considering that the Chinese giant had only released their first smartphone in 2009. The three giants, namely, Samsung, Huawei and Apple, dominate the smartphone market with a combined market share of over 50 per cent.

Huawei's success in the smartphone industry is attributed with providing consumers with the latest technology, thanks to the company's ethos of high investment in research and development and production. The firm's engagement with innovation is evident within their workforce, as approximately 80,000 people are employed within research and development, which is around 45 per cent of total workforce. Moreover, Huawei invested approximately $13.2 billion (£10.3 billion) in R&D in 2017. Huawei's two-pronged strategy, whereby they use their fast-growing sub-brand Honor to capture the mid-tier segment and its premium Huawei-branded smartphones at the top end of the market, allows the firm to reap synergistic benefits and lead to its broad appeal. Given Huawei's success in the smartphone industry, it might be assumed that Huawei's smartphone models may be among the most popular handsets, but this is not the case. Huawei has an extensive product portfolio and its breadth of sales make up for lack of depth in sales. Nevertheless, there is perhaps a need to streamline their range of handsets.

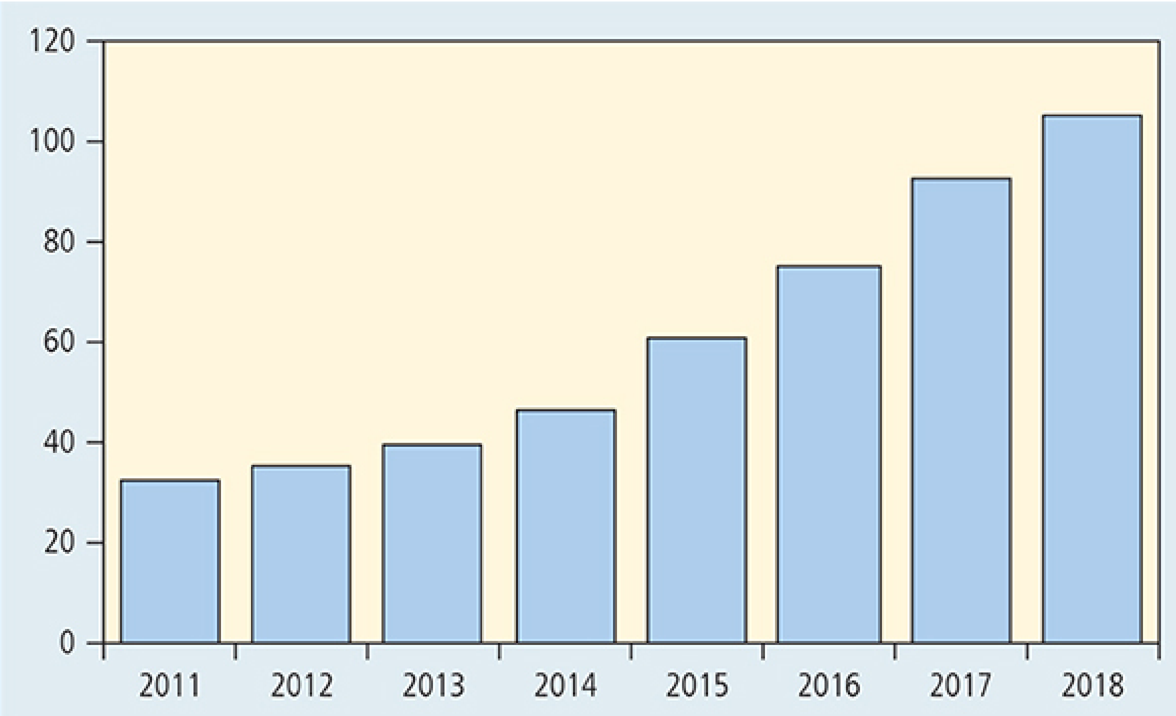

Figure 14.8 **Huawei's Revenue Growth 2009–17 ($ billions)**

Source: BBC (2018).

Although Huawei operates in over 170 countries, the firm failed to launch its products in the US as the government deemed the organisation to be a security threat; however, this failure has forced the firm to redouble their efforts in Asia and Europe, which has undoubtedly led to success. Perhaps worryingly though, Huawei is still dependent on China for over 50 per cent of its revenue. Issues of security have continued to plague the company, coming to media scrutiny in late 2018 for reported breaches. On the 1 December 2018, Huawei's Chief Financial Officer, Meng Wanzhou, was arrested in Canada, on suspicion of US fraud charges which concerned the alleged breaking of US sanctions on Iran.

Following Meng's arrest, China was reportedly using Huawei as a tool to spy on rival nations. Huawei responded to these allegations by asserting that the relationship between Huawei and China was strictly business-related and that the telecoms giant did not give anything back to China's government other than the relevant business taxes. However, given the propensity for state control in China, many critics have questioned the independence of Huawei. One of the reasons

why Huawei was under such high levels of scrutiny was partly because Huawei's founder, Ren Zhengfei, was previously an engineer in the Chinese army before joining the Communist Party in 1978. Given Huawei's accusations the firm was eager to portray itself as a private company owned, with little to no ties to the Chinese government beyond those of a law-abiding taxpayer. Although little evidence surfaced to show that Huawei was spying on rival nations, other countries appeared fearful of the control that the Chinese government could assert over Huawei. In particular, there was concern that collusion between the firm and the government could support politically motivated cyber-attacks and enable the Chinese state to acquire access to highly sensitive networks.

Given the aforementioned security concerns, a number of countries were quick to respond. Australia, Japan and New Zealand followed the US's approach to ban Huawei products relating to the next-generation mobile network. Furthermore, President Donald Trump also suggested that there may be a ban on US companies buying Huawei's products. Although Canada has not issued a ban on Huawei products, they reportedly conducted a thorough review of Huawei's portfolio. BT, a UK telecommunications provider, has removed Huawei equipment from its 5G network and although the UK has also not banned Huawei products, the Chinese giant will be regularly subjected to security testing by the UK's intelligence agency. Contrasting these approaches, Germany stated that they oppose any banning of suppliers, including Huawei from their 5G networks.

Despite being the second largest smartphone-producer in the world, Huawei experienced sanctions against their products in a range of countries due to security issues. Importantly, in 2018 the US and China were in the middle of a trade dispute, with both nations imposing tariffs and fighting over technology and patents. There is little evidence to suggest that Huawei have been liaising with China to breach security systems, but the autocratic nature of the Chinese regime makes Western leaders anxious. Many critics have questioned the extent to which China would allow Huawei to remain truly independent, particularly given its potential value for national security purposes. Alongside all of the factors that determine firm-level competitive advantage, international politics is also a critical factor in determining the success of MNEs in global markets.

Websites: https://www.theverge.com/2017/9/6/16259810/huawei-apple-global-smartphone-sales; https://www.theguardian.com/technology/2018/aug/01/huawei-beats-apple-smartphone-manufacturer-samsung-iphone; https://www.bbc.co.uk/news/technology-46701005?intlink_from_url=https://www.bbc.co.uk/news/topics/cjnwl8q4qz2t/huawei&link_location=live-reporting-story; https://www.reuters.com/article/us-japan-china-huawei/japan-government-to-halt-buying-huawei-zte-equipment-sources-idUSKBN1O600X; https://www.bbc.co.uk/news/business-46480208 https://www.bbc.co.uk/news/business-46480208; https://www.ctvnews.ca/world/trump-may-ban-u-s-companies-from-buying-huawei-tech-report-1.4234103

1 Discuss the reasons why Huawei have been so successful in the smartphone industry.

2 Why have many countries deemed Huawei to be a security threat?

3 What actions have countries taken, given the security concerns that relate to Huawei's relationship with the Chinese government?

REAL CASE

Problems with ports

Ports are important. Despite the shift to services and intangibles, trade in physical goods has continued to grow significantly. Today, almost 10 billion tons of seaborne trade flows through the world's ports each year. But there is a great deal of variability in the costs of using different transport routes and shipping infrastructures. Shipping a container from a company in Sub-Saharan Africa costs almost twice as much as shipping it from India and it takes six times longer than shipping it from the USA. To address these problems, significant aid funding, particularly from the World Bank, has focused on reducing these trade costs and improving shipping infrastructure to support trade. In the process we have learned more about how various forms of corruption create some of these additional costs and inefficiencies in many ports around the world.

Here we focus primarily on ports in Sub-Saharan Africa, because the higher costs and risks associated with these undermine the growth of trade, FDI and the development of local firms in countries that desperately need this development. However, a brief comparison with Japan also shows that different forms of political risk are prevalent in ports around the world.

Over 90 per cent of African imports and exports go via the continent's 100-plus port facilities. These handle 6 per cent of the world's shipping cargo traffic and an estimated 3 per cent of the world's container traffic. Seven key ports manage the bulk of this traffic: Durban (South Africa), Mombasa (Kenya), Djibouti, Lagos (Nigeria), Abidjan (Ivory Coast), Suez Canal (Egypt) and Tangier (Morocco). Durban alone handles over 4,500 vessels yearly and manages trade worth over $45 billion. Things do not seem to be slowing down in the Port of Durban, as 2.95 million containers passed through this port from 2018 to 2019, which was a growth of 9.5 per cent from the previous year. Moreover, Durban handled an impressive 487,000 units in 2018, which is the highest since 2013 when the port handled a throughput of 503,000 units.

Source: age fotostock/Alamy Stock Photo

Some of the relatively higher costs of African ports are due to the lower economies of scale associated with their smaller size as well as poorer dockside infrastructure and facilities. It is also clear that corruption plays a major role in increasing costs, delays and uncertainty. One study of firms' behaviour in relation to corruption in ports, with evidence from Maputo (Mozambique) and Durban, found that public officials in charge of service delivery in ports can engage in 'collusive corruption' and/or 'coercive corruption', depending on the context. The first is when public officials and private sector managers collude to share the profits of illegal transactions; the second is when a public bureaucrat coerces a private sector manager into paying an additional fee to gain access to the service. The study concludes that 'collusive corruption' is associated with higher usage of the corrupt port and 'coercive corruption' is associated with reduced demand for port services (Sequeira and Djankov, 2014).

This study finds that 'bribes are high, frequent and not equalised across ports.' In Maputo there is a 53 per cent probability that a bribe will need to be paid, compared to 36 per cent in Durban. Moreover, the amount paid is three times as high in Maputo as in Durban. The average bribe paid in Maputo increases the total port costs for a 20-foot container by 129 per cent (compared to 32 per cent in Durban) and adds 14 per cent (compared to 4 per cent in Durban) to the total shipping costs on any route connecting southern Africa to the Far East. However, it is worth noting that some

bribes are paid for avoiding tariff duties, so they can reduce the overall costs of trade to the private agent but reduce the amount of funds received by legitimate public sector organisations.

The incentives for bribery are clear, given that the average bribe in Maputo represents about a quarter of the monthly salary of a customs official (but just 4 per cent in Durban), and taking bribes can increase annual salaries by 600 per cent. But the beneficiaries vary across ports, depending on the context and conditions. The Sequeira and Djankov (2014) study found that the main recipients of bribe payments in Maputo are customs officials (80 per cent) and the primary reason for payment is for tariff evasion (41 per cent of the time). However, in Durban, clerks in the document department and security agents receive over 50 per cent of all bribes. The latter are paid extra to watch over cargo on the docks and prevent it being stolen or removed while waiting for clearance (i.e., for doing their job).

Further up the east coast of Africa, Kenya's main port of Mombasa has also been studied to understand the cause of higher costs and delays for international shipping firms. According to one study, the key reasons are, in order of importance: security and theft; bureaucratic forwarding and clearing procedures (cost increases due to procedural delays); customs and excise harassment (leading to corruption, otherwise further delays); obsolete, poorly maintained port handling and lifting equipment (leading to further delays); high tariffs for poor service; and just plain corruption.

As with many other kinds of support infrastructure and service operations owned or regulated by government agencies in less developed countries, what they do, how they do it and how much it costs vary a great deal depending on the institutional structures and values that dominate locally. In some parts of Africa, a generic 'culture of corruption' stems from the short-term and self-serving perspective of individuals in positions of power. This may be because of the fragile nature of the political systems in which they operate. A change of government, or the replacement of one senior-level patron with another, triggered by tribal or other conflicts, can mean officials can lose their jobs and their means to an above-average existence.

Many forms of corruption exist in Kenya, including petty corruption (to obtain a small service or get it done faster), corruption by harassment (where the private sector is harassed into bribing), political corruption (soliciting bribes for favours) and grand-scale corruption (evading tax on a

grand scale or fixing government tenders worth hundreds of millions of dollars). Political interference in Kenya's ports takes a number of forms. Particularly important are:

1. Political appointments to key management functions, resulting in unqualified and sometimes corrupt personnel in critical power positions.
2. Political undercurrents in labour recruitment; tribal affiliations and ruling political party affinity lead to biases in the recruitment of low-wage labour as well as more senior posts.
3. Regular interference in tender allocations; for government-related tenders, kickbacks (bribes) are necessary to win contracts.
4. Well-connected port users have an advantage and can queue-jump or get better services or security protection, creating frustration for other port users.

Beyond these kinds of problems, small-scale corruption is rife. Port users may need to bribe petty officials to release goods or pay security guards protection money to avoid theft (which they can often be responsible for). The uncertainty for foreign managers unfamiliar with these local rules of the game is increased by the constant change in key officials and their political affiliations. Moreover, bribing the wrong person not only is a waste of money, but also can create big problems for anyone caught 'playing the game' during sporadic government crack-downs.

Finally, by way of contrast, it is worth noting that ports in other parts of the world are not immune from these problems. In 2016, the port of Kobe witnessed a rise in container traffic by 3.5 per cent in 2016 to 2.80 million 20-foot equivalent. Given this, Kobe overtook the port of Yokohama, which meant that Kobe was Japan's second-biggest container port after Tokyo. However, Japan's ports have long been slower and more expensive than most other ports in the Asia region. Part of the explanation lies in another form of corruption, a complex cartel which the Japanese government, with pressure from the USA, has finally started to tackle. At the end of the 1990s, when the problem was at its worst, it took three to four days to clear customs and immigration in a Japanese port and cost $36,000 to $40,000 to unload a vessel, compared to one day in most other ports and $11,000 in Singapore and $16,000 in the United States.

One major source of these additional costs was the near-monopoly power of the Japan Harbor Transportation Association (JHTA). At its height the JHTA was a cartel of 2,000 member

organisations encompassing the waterfront services (stevedoring, cargo handling and transfer documentation) across 130 ports in Japan. It was run by Chairman Takashima, the so-called king of the waterfront, eight vice chairmen and 85 directors from the various port companies. The JHTA was responsible for two kinds of anti-competitive practices. First, the system of prior consultations between shipping companies and the labour unions of cargo-handling companies took place via JHTA. Foreign firms could not select which firm handled their cargo on the basis of quality or cost; JHTA chose for them. It also controlled schedule changes, changes in berths and route calls, and centrally regulating and slowing down the entire process. There was no formal documentation, application or appeals procedure; the system operated through informal lobbying. Second, licensing requirements for technical operators and stevedoring firms acted as barriers to foreign firms (and to non-cartel Japanese firms) entering the market. Foreign firms were not allowed to perform stevedoring or port services for themselves or appoint third parties without the consent of JHTA.

The JHTA connected both government departments and yakuza (mafia-like groups in Japan) in ways that non-Japanese cannot easily understand. A US Embassy study found that 110 ex-officials from the Ministry of Transport had moved to senior management positions in waterfront companies. This is amakudari (literally, 'descent from heaven'), a system of secondment or 'semi-retirement' for bureaucrats common in Japan. In 2005 the Japanese government promised to take measures to reduce the cost of using its main ports by 30–40 per cent to 'arrest a dramatic drop in competitiveness' in relation to other Asian ports. However, the anti-competitive networks described above still persist as a symbol of the socio-political nature of this sector in Japan.

Sources: Sandra Sequeira and Simeon Djankov, 'Corruption and firm behavior: evidence from African ports', London School of Economics and Political Science, 2014, http://www.nes.ru/dataupload/files/JIE_Corruption%20in%20Ports%202014.pdf; 'Africa's biggest shipping ports', *BusinessTech*, 8 March 2015, http://businesstech.co.za/news/general/81995/africas-biggest-shipping-ports/; Mariko Sanchanta, 'Japanese government to cut main port costs by up to 40%', *Financial Times*, 7 January 2005, p. 3; Michiyo Nakamoto, 'Port city seeks to nurture new enterprises', *Financial Times*, 27 April 2004, p.

3; Parit Shah, ‘A strategy for the port of Mombasa’, unpublished MBA dissertation, Warwick Business School, Coventry, 2004; US Embassy in Tokyo, *Third Report to the Leaders on the US–Japan Regulatory Reform and Competition Policy Initiative*, 8 June 2004, http://tokyo.usembassy.gov/e/p/tp-20040609–01.html; Lucy Kilalo, ‘10 charged with stealing at port’, *The Daily Nation*, 12 March 2003; UNCTAD, *Review of Maritime Transport 2014*, http://unctad.org/en/PublicationsLibrary/rmt2014_en.pdf; https://worldmaritimenews.com/archives/273581/port-of-durban-container-volumes-surge-in-2018/; https://www.joc.com/port-news/international-ports/kobe-was-japans-second-biggest-container-port-2016_20170331.html.

1 What are the main differences in the barriers and risks faced by foreign firms across the different port systems referred to in the case?

2 Why is it difficult for foreign firms to challenge these unfair practices in either Africa or Japan?

3 How could a manager looking to use these ports minimise the risk and uncertainty created by local ways of doing things?

NOTES

1 Witold J. Henisz, Edward D. Mansfield and Mary Ann Von Glinow, 'Conflict, security, and political risk: international business in challenging times', *Journal of International Business Studies*, vol. 41, no. 5 (2010), pp. 759–64; S. Sakarya, M. Eckman and K. H. Hyllegard, 'Market selection for international expansion: assessing opportunities in emerging markets', *International Marketing Review*, vol. 24, no. 2 (2007), pp. 208–38; K. D. Miller, 'A framework for integrated risk management', *Journal of International Business* (summer 1992), pp. 311–31; D. Kern, 'The evaluation of country risk and economic potential', *Long Range Planning*, vol. 18, no. 3 (1985), pp. 17–25; and M. Perlitz, 'Country portfolio analysis—assessing country risk and opportunity', *Long Range Planning*, vol. 18, no. 4 (1985), pp. 11–26.

2 S. C. Collinson and J. Holden, 'Decision-making and market orientation in the internationalization process of small and medium-sized enterprises', *Management International Review* (MIR), vol. 45 (2005), pp. 413–36.

3 The Business Environment Risk Information (BERI) model contains a variable that it calls 'Mentality' in its formula for national risk assessment. The idea behind inclusion of this concept is that there can be a national attitude, a mentality that would be resistant or corrosive to foreign investment and prevent efficient and productive investment and business operations. Details about the criteria and methodology used by BERI are available at http://www.beri.com.

4 Ilan Oshri, Julia Kotlarsky and Leslie P. Willcocks (eds.), *The Handbook of Global Outsourcing and Offshoring* (Basingstoke:

Palgrave, 2009).

5 The bargaining environment can be captured by the structure of a complex, interrelated network. The bargaining power of individual constituencies is related to their basis of power, network position, bargaining outcome preferences and motivation to influence bargaining (James Nebus and Carlos Rufin, 'Extending the bargaining power model: explaining bargaining outcomes among nations, MNEs, and NGOs', *Journal of International Business Studies*, vol. 41, no. 6 (2010), pp. 996–1015).

6 John R. Schermerhorn, Jr., 'Language effects in cross-cultural management research: an empirical study and a word of caution', *National Academy of Management Proceedings*, 1987, pp. 102–5; S. C. Collinson and A. M. Pettigrew 'Comparative international business research methods: pitfalls and practicalities', Chapter 27 in A. M. Rugman (ed.), *The Oxford Handbook of International Business,* 2nd ed. (Oxford: Oxford University Press, 2009).

7 See https://www.transparency.org/research/gcr.

BIBLIOGRAPHY

Brown, Christopher L., Cavusgil, S. Tamer and Lord, A. Wayne. 'Country-risk measurement and analysis: A new conceptualization and managerial tool', *International Business Review*, vol. 24, no. 2 (2015).

Christensen, Dane M., Dhaliwal, Dan S., Boivie, Steven and Graffin, Scott D. 'Top management conservatism and corporate risk strategies: Evidence from managers' personal political orientation and corporate tax avoidance', *Strategic Management Journal*, vol. 36, no. 12 (2015).

Chen, Charles J. P., Yuan Ding, Kim and Chansog, Francis. 'High-level politically connected firms, corruption, and analyst forecast accuracy around the world', *Journal of International Business Studies*, vol. 41, no. 9 (December 2010).

Coeurderoy, Régis and Murray, Gordon. 'Regulatory environments and the location decision: evidence from the early foreign market entries of new-technology-based firms', *Journal of International Business Studies*, vol. 39, no. 4 (June 2008).

Darendeli, Izzet Sidki and Hill, T. L. 'Uncovering the complex relationships between political risk and MNE firm legitimacy: Insights from Libya', *Journal of International Business Studies*, vol. 47, no. 1 (2016).

Desbordes, Rodolphe. 'The sensitivity of US multinational enterprises to political and macroeconomic uncertainty: a sectoral analysis', *International Business Review*, vol. 16, no. 6 (2007).

Figueira-de-Lemos, Francisco, Johanson, Jan and Vahlne, Jan-Erik. 'Risk management in the internationalization process of the firm: a note on the Uppsala model', *Journal of World Business*, vol. 46, no. 2 (2011).

Filatotchev, Igor, Strange, Roger, Piesse, Jenifer and Yung-Chih Lien. 'FDI by firms from newly industrialized economies in emerging markets: corporate governance, entry mode and location', *Journal of International Business Studies*, vol. 38, no. 4 (July 2007).

Goerzen, Anthony, Sapp, Stephen and Delios, Andrew. 'Investor response to environmental risk in foreign direct investment', *Management International Review*, vol. 50, no. 6 (December 2010).

Heidenreich, Stefan, Mohr, Alexander and Puck, Jonas. 'Political strategies, entrepreneurial overconfidence and foreign direct investment in developing countries', *Journal of World Business*, vol. 50, no. 4 (2015).

Henisz, Witold J. and Zelner, Bennet A. 'Legitimacy, interest group pressures and change in emergent institutions: the case of foreign investors and host country governments', *Academy of Management Review*, vol. 30, no. 2 (2005).

Huang, Tao, Wu, Fei, Yu, Jin and Zhang, Bohui. 'Political risk and dividend policy: Evidence from international political crises', *Journal of International Business Studies*, vol. 46, no. 5 (2015).

Jia, Nan and Mayer, Kyle J. 'Political hazards and firms' geographic concentration', *Strategic Management Journal*, vol. 38, no. 2 (2017).

Jiménez, Alfredo, Luis-Rico, Isabel and Benito-Osorio, Diana. 'The influence of political risk on the scope of internationalization of regulated companies: insights from a Spanish sample', *Journal of World Business*, vol. 49, no. 3 (2014).

Keating, Robert J. and Abramson, Neil R. 'A new framework in the quest for cultural understanding using Australia, Thailand and Japan as an example', *International Journal of Business Studies*, vol. 17, no. 1 (June 2009).

Kobrin, Stephen. 'When does political instability result in increased investment risk?' *Columbia Journal of World Business*, vol. 13, no. 3 (1978).

Kumar, Rajesh, Rangan, U. Srinivasa and Rufin, Carlos. 'Negotiating complexity and legitimacy in independent power project development', *Journal of World Business*, vol. 40, no. 3 (August 2005).

Maitland, Elizabeth and Sammartino, André. 'Decision making and uncertainty: The role of heuristics and experience in assessing a politically hazardous environment', *Strategic Management Journal*, vol. 36, no. 10 (2015).

Peng, Mike W., Wang, Denis Y. L. and Jiang, Y. 'An institution-based view of international business strategy: a focus on emerging economies', *Journal of International Business Studies*, vol. 39, no. 5 (July/August 2008).

Ramamurti, Ravi and Hashai, Niron (eds.). *The Future of Foreign Direct Investment and the Multinational Enterprise: 15*, Research in Global Strategic Management series (Bingley: Emerald Group Publishing, 2011).

Rothaermel, Frank T., Kotha, Suresh and Steensman, H. Kevin. 'International market entry by US internet firms: an empirical analysis of country risk, national culture, and market size', *Journal of Management*, vol. 32, no. 1 (2006).

Sauvant, Karl, *Yearbook on International Investment Law and Policy 2009–2010* (New York: Oxford University Press, 2010).

Scherer, Andreas Georg and Palazzo, Guido. 'The new political role of business in a globalized world: a review of a new perspective on CSR and its implications for the firm, governance, and democracy', *Journal of Management Studies*, vol. 48, no. 4 (2011).

Stevens, Charles E., Xie, En and Peng, Mike W. ‘Toward a legitimacy-based view of political risk: The case of Google and Yahoo in China’, *Strategic Management Journal*, vol. 37, no. 5 (2016).

Strange, Roger, Filatotehev, Igor, Yung-chih, Lien and Piesse, Jenifer. ‘Insider control and the FDI location decision’, *Management International Review*, vol. 49, no. 4 (August 2009).

WWW RESOURCES

http://www.tdctrade.com
http://www.wto.org
http://miga.org
http://www.economist.com/countries
http://www.eiu.com
http://transparency.org
http://www.fraserinstitute.ca
http://www.freetheworld.com
https://datacatalog.worldbank.org/dataset/doing-business
https://www.transparency.org/research/gcr

Chapter 15

INTERNATIONAL FINANCIAL MANAGEMENT

Contents

Objectives of the chapter

This chapter discusses the opportunities and challenges that face multinational enterprises (MNEs) in terms of managing their finances, because they operate in a multicurrency, segmented-market world.

The specific objectives of this chapter are to:

1. *Compare* and *contrast* how polycentric, ethnocentric and geocentric solutions are used in determining the financial planning and controlling authority that is given to subsidiaries.
2. *Study* some of the most common techniques that are used in managing global cash flows, including funds positioning and multilateral netting.
3. *Examine* foreign exchange risk strategies that are used to protect the multinational against transaction, translation and economic exchange risks.
4. *Explain* how capital budgeting is carried out in a multinational firm.
5. *Describe* how international financing opportunities for an MNE differ from those available to a domestic firm.
6. *Provide* examples of international financial strategies currently being used by multinationals.

ACTIVE LEARNING CASE

Financial transparency at Siemens

Siemens was founded by Werner von Siemens and Johann Georg Halske in 1847, with the invention of the telegraph. Headquartered in Germany, Siemens has grown to become a global diversified technology company primarily specialising in energy, healthcare and infrastructure industries. In 2018, Siemens' revenue totalled approximately $93 billion and employed a workforce of 379,000 people, located in nearly every country of the world, Siemens has truly become a global MNE.

In 2006, Siemens faced a major corruption scandal which spanned over 60 per cent of total global operations, with fines amounting to $1.6 billion. Corrupt activities involved the securing of contracts to provide power generation equipment in Italy, telecommunications infrastructure in Nigeria and national identity cards in Argentina via the use of bribes. The firm's corporate governance structures and culture came into question as its values and ethics appeared to be compromised by an aggressive growth strategy and a complicated, decentralised structure with little oversight from the main headquarters.

Most of the German investigation focused on a vast number of artificial consulting contracts and a tortuous system of accounts which helped the organisation secure business from overseas. Ironically, the findings illustrated how a particular Saudi Arabian organisation threatened to expose the bribes to the Securities and Exchange Commission (SEC), unless Siemens cooperated by supplying an additional $910 million in consulting fees. Siemens ended up paying an additional $50 million in order to settle this form of 'blackmail', leading to observations that there really is 'no honour among thieves'. Organisations that frequently use 'fly-by-night' consultants and 'off the books' accounts have tended to signal to various authorities that they may be engaging in illegitimate practices.

Replacing Klaus Kleinfeld, Peter Löscher was appointed as the new CEO in 2007 and was primarily responsible for developing a culture of integrity among the Siemens workforce. This was a major challenge as many board members had resigned and several executives were facing legal prosecution. Following his appointment, Löscher drastically restructured the top three levels of management and approximately 65 per cent of senior executives were replaced. Löscher was the first

outsider appointed as CEO and he invested a significant amount of time overseeing the detailed operational activities of employees within the organisation. He discovered a widespread sense of disappointment among workers, stemming from past leadership failures which had ultimately impacted workers' engagement and productivity levels.

Tackling corrupt practices head on, with the exclusion of directors Siemens offered their workforce an 'amnesty'. This meant that employees who came forward and admitted to being involved in bribery were guaranteed that they could keep their job. In contrast, employees who did not wish to share any information and who later were found to be involved in such matters were to be fired. It has been reported that approximately 130 staff members came forward.

Key changes were made involving the corporate governance and structure of the board. Previously, it had been operating on two tiers, where reports were issued to the executive board, which lacked an in-depth understanding of the business as a whole. In essence, Siemens was passing down pre-approved decisions without evaluating them effectively. Löscher enforced the breakdown of the original two-level system into a single board which consisted of eight individuals who had acquired a deep understanding of each of the industries within Siemens. In addition, this board included two new positions overseeing supply chain management and sustainability, and legal counsel and compliance. Prior to 2007, operations across 190 different countries had been organised into 70 global clusters. This was reduced to a total of 20 clusters in order to reduce the complexity of operations and increase accountability and oversight. By 2012 the number of clusters was further reduced to 12, managed by a steering group who met every quarter.

One of the key changes to the board was the appointment of US lawyer Peter Solmssen, who was responsible for compliance within Siemens. The compliance team held positions in crucial functions within Siemens and expanded from 170 employees to approximately 600 employees in 2011. The Siemens Compliance Organization became independent from Siemens itself, reporting directly to Siemens' main board.

Solmssen highlighted the need for sustainability. However, unlike conventional visions of sustainability, where firms prioritise the reduction of emissions and improve efficiency levels, Solmssen believed sustainability should be viewed more broadly as underlying every aspect of a global business culture. Solmssen argued that anti-corruption practices could be established at little

cost and with minimal disruption. John Garred, Siemens' UK Regional Officer, suggested that Siemens' anti-corruption policy was built on three fundamental principles: prevent, detect and respond. In essence, this meant training the workforce regarding anti-corruption policies, monitoring whether these policies were indeed working, and responding robustly when violations were uncovered. Garred also identified the importance of management accountants as key compliance regulators.

Management accountants consistently conduct control checks on payments and can explore anomalies in the system to assess compliance; they are the 'eyes and ears' of the compliance team. Furthermore, management accountants play a vital role in guiding the ethics of decision making in conjunction with the procedural and regulatory aspects of compliance. In essence, management accountants often go well beyond simply adding and subtracting, but can analyse and interpret information from a range of perspectives, adding significant value to an organisation's strategic goals.

Following the corruption scandal, Siemens recognised that in order to rebuild trust both internally and externally, structural, procedural and cultural interventions had to be implemented simultaneously. Siemens has consistently highlighted the need for open communication and transparency. The firm has introduced global programmes which aim to bridge the gap between top management and lower-level employees via the use of middle management. For example, 'integrity dialogues' are mentioned during sales meetings, to openly discuss any ethical issues and how these should be handled as part of the contracting process. In order to improve transparency, Siemens also externally reports compliance-related developments. The reporting of ethical information is seen as one important dimension of good corporate governance, as it allows both management and stakeholders to gain an insight into the impact of leadership activities within the firm.

Siemens Chief Financial Officer, Joe Kaeser, was appointed as the new CEO in 2013 and revised the company's long-term strategy. Kaeser once stated that 'Compliance is not a program, but the foundation of sustainable business', and suggested that focusing on the long term, developing real and sustainable values, and considering stakeholders are principles which ensure good corporate governance.

Conclusion

Siemens experienced a difficult period during the corruption scandal, but via the use of effective corporate governance, financial reporting and auditing practices, it has managed to get back on track. The firm needs to continually demonstrate that it has the appropriate monitoring and compliance processes in place, as its current and past activities are still under scrutiny. In 2015 an investigation found that corrupt practices within Siemens could be traced back to 1998 when approximately $80 million in bribes were paid in order to secure the sale of equipment to Greece's dominant telecom operator, OTE. Moreover in 2018, Eberhard Reichert, a former executive at Siemens, pleaded guilty concerning one of the bribery cases in Argentina. This involved payments to government official in Argentina, which was said to be worth over a $1 billion, over a contract for national identity cards. So lessons remain to be learned. There are significant costs involved in compliance and firms also need to accept that they may lose contracts to less ethical companies. But there are also significant costs not only in legal expenses and fines, but also in terms of lost trust and reputation, when corrupt practices are uncovered.

Sources: Siemens, *Annual Report*, 2012, 2018; 'Rethinking the value chain, ethical culture change at Siemens: a case study', *CGMA Briefing*, 2014; Graham Dietz and Nicole Gillespie, 'Rebuilding trust: how Siemens atoned for its sins', *Guardian*, 26 March 2012; Bruce Watson, 'Siemens and the battle against bribery and corruption', *Guardian*, 18 September 2013; Donna Boehme and Joe Murphy, 'No place to hide: early lessons from the Siemens case', *ETHIKOS* (November/December 2007), accessed from http://compliancestrategists.com/csblog/wp-content/uploads/2014/01/NovemberDecember-2007-Ethikos-PDF-Download.pdf; Siri Schubert and T. Christian Miller, 'At Siemens, bribery was just a line item', World Business, *New York Times*, 20 December 2008; Jessica Dye, 'Former Siemens executive pleads guilty in $100m bribery case', *Financial Times,* 15 March 2018.

1. **How did Siemens restructure its parent–subsidiary relationships between 2007 and 2012 in terms of using a polycentric, ethnocentric or geocentric solution?**
2. **How is Siemens exposed to exchange rate risks and what kinds of hedging strategies could it employ to mitigate these risks?**

3. **If Siemens believes that the euro is going to appreciate in relation to the US dollar, how is it likely to deal with receivables and payables?**
4. **When Siemens is looking to invest in its foreign affiliates around the world, what are some of the important considerations in choosing among alternative financing sources?**

INTRODUCTION

Any firm with affiliates in at least two countries (even with a simple sales office abroad) needs to deal with differences in the financial environments of those countries – differences in their tax systems, their currency systems and numerous other areas. Can you imagine trying to keep the books of a company such as Johnson & Johnson, which is required to maintain financial records according to the different accounting standards in the dozens of countries where it operates, plus records for use in internal control? Beyond the chores of record keeping, the firm operating at this level obtains opportunities to transfer funds (and products) between countries, utilise financial markets in each country to serve its global needs, and diversify its risks internationally. Increasing numbers of MNEs, such as Ford and General Electric, are building internal financial institutions so that they can take advantage of these opportunities around the world. This chapter explores the opportunities and problems of firms in such an environment.

National financial markets and the euromarkets were discussed in Chapter 7; here the emphasis is on using these markets to optimise the financial position of the multinational firm. The issue of transaction exchange risk was treated in Chapter 7; this chapter considers such risk in the context of a firm that does repeated international business and maintains long-term assets abroad. Finally, we consider the full set of financial issues in a firm whose subsidiaries in different countries compete for use of the available financial resources. This chapter treats the topic of multinational financial management as a whole.

The chapter is structured to cover major issues in corporate finance as they apply to the international context. Basic financial management can be divided

into two broad headings: (1) choice and management of *sources* of funds; and (2) choice and management of *uses* of funds. At the international level, exchange risk management must be added. Figure 15.1 depicts the topics that constitute the substance of the chapter. Overall financial management requires *control* over each type of decision depicted in the figure, especially since financial managers in each affiliate may make decisions that affect the total corporation's financial position.

In the next section, we explore aspects of the parent–subsidiary financial relationship within the MNE. Then the discussion turns to the issue of managing cash flows in the MNE. Next, we consider a more comprehensive presentation of exchange risk management than that given in Chapter 7. After that, we look at the two sides of financial management in the context of the MNE: namely, use of available funds (particularly for capital budgeting) and financing for the firm's short- and long-term needs. A section on control of the financial activities in an MNE follows. And finally, some strategic considerations for the firm in international finance are presented.

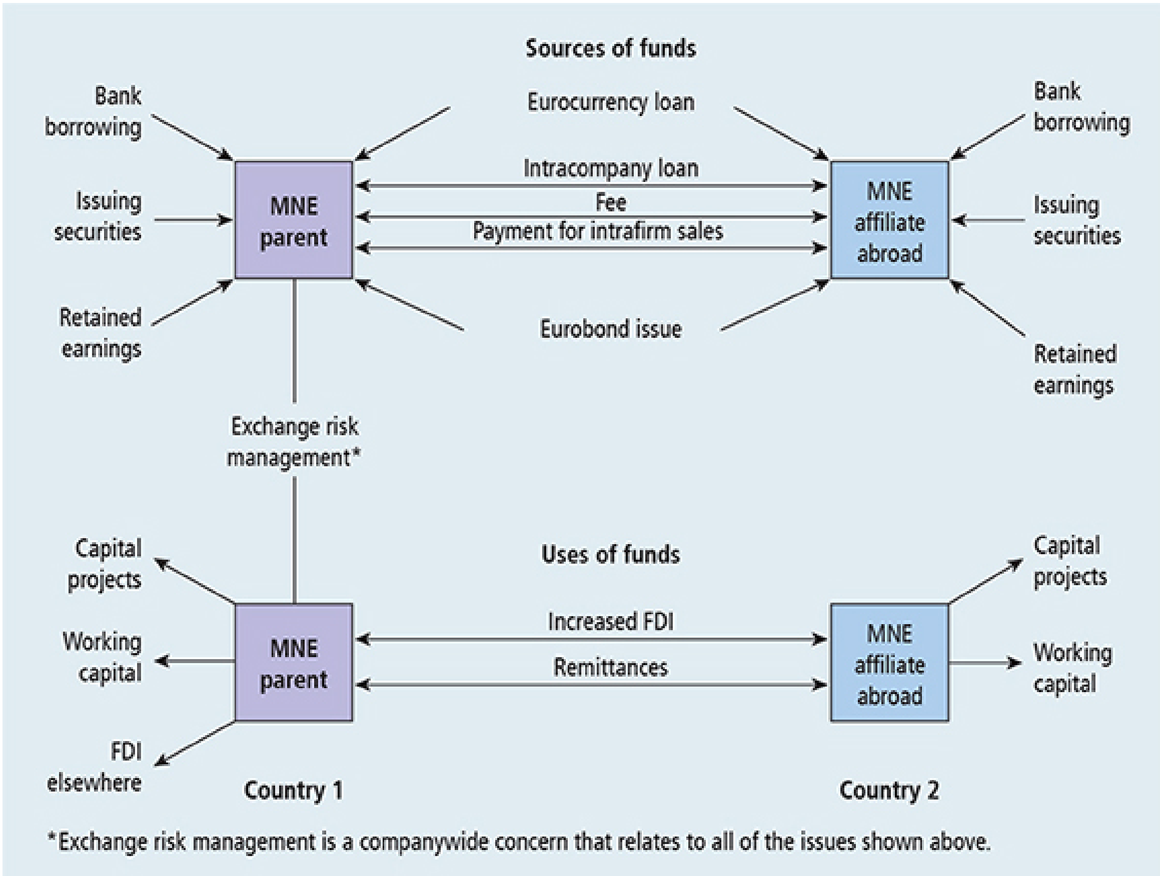

Figure 15.1 **Financial management in the MNE**

DETERMINING PARENT–SUBSIDIARY RELATIONSHIPS

Because finance is such an important area of operations, it is critically important that parent companies firmly establish the relationships that will exist regarding financial planning and control authority. On the one hand, each branch or subsidiary should be responsible for its own planning and control system. On the other hand, there must be some central control in order to coordinate overall operations and to ensure both efficiency and profitability. In addressing this challenge, MNEs tend to opt for one of three managerial solutions: polycentric, ethnocentric or geocentric, just as these choices are used in other strategic areas. We have presented these terms earlier in the book, in Chapter 5 (see Table 5.3) as ways of managing different national cultures, and in Chapter 8 (see Table 8.1) as types of strategic orientation for MNEs. Here we discuss how finances would be managed differently in each type of MNE structure.

Polycentric solution

A **polycentric solution** is to treat the MNE as a holding company and to decentralise decision making to the subsidiary levels. In this arrangement, financial statements are prepared according to generally accepted accounting principles in both the overseas subsidiary's and the parent's home country, and the subsidiary's performance is evaluated against that of similar domestic and foreign concerns.

The advantages are that decisions are made on the spot by those most informed about market conditions, and international subsidiaries tend to be more flexible, motivated, efficient and competitive. On the other hand, this

solution reduces the authority of the home office. It can also result in competition between different international subsidiaries and lower overall profits for the company.

Ethnocentric solution

The **ethnocentric solution** is to treat all foreign operations as if they were extensions of domestic operations. In this case each unit is integrated into the planning and control system of the parent company.

The advantage of this system lies in having strong, centralised control and some economies of scale in the HQ-based finance function. Cash not needed for day-to-day operations can also be invested in marketable securities or transferred to other subsidiaries or branches that need **working capital**. The main drawback of this solution is that it limits the funds available for the individual subsidiary and reduced its flexibility and responsiveness to local market conditions.

Geocentric solution

The **geocentric solution** is to handle financial planning and controlling decisions on a global basis. These decisions are typically influenced by two factors. One is the nature and location of the subsidiary. For example, British investment in North America has predominantly been via holding companies, the polycentric approach, since the quality of local management largely rewards decentralisation. Conversely, investment in developing countries has typically been more centralised, with the parent company maintaining close control of financial expenditures. The second influencing factor is the gains that can be achieved by coordinating all units in a carefully synchronised way. When an MNE's overseas units face a myriad of tax rates, financial systems and competitive environments, it is often more efficient to centralise most of the financial control decisions because this is the best way to ensure that

profit and efficiency are maximised. For example, if two subsidiaries are equally able to sell a particular product to a major customer, with centralised financial planning the parent company could ensure that the sale would be made by the unit located in the country with the lowest corporate income tax rate. Additional examples of the ways in which financial operations could be directed by using a geocentric solution are seen in the management of global cash flows.

Active learning check

Review your answer to Active Learning Case question 1 and make any changes you like. Then compare your answer to the one below.

1 How did Siemens restructure its parent–subsidiary relationships between 2007 and 2012 in terms of using a polycentric, ethnocentric or geocentric solution?

Arguably Siemens moved from a polycentric structure towards a more ethnocentric structure, because of its concerns over corruption and compliance. More control and oversight was brought under the main board and decision-making power became more centralised.

MANAGING GLOBAL CASH FLOWS

One of the key areas of international financial management is the careful handling of global cash flows. There are a number of ways in which this is done. Three of the most important ones are the prudent use of internal funds flows, the use of funds positioning and the use of **multilateral netting**. The following sections examine each of these three.

Internal funds flows

When an MNE wants to expand operations or fund activities, one of the simplest ways of obtaining necessary funding is from internal sources such as working capital, which is the difference between current assets and current liabilities. For example, if Tata's UK subsidiary wants to hire more employees, it may be able to pay for this payroll increase out of the funds it generates from ongoing operations. Another way of raising money internally is by borrowing from a local bank or from the parent company. For example, an MNE's Chilean subsidiary will get a loan from the parent company or the German subsidiary and then repay the money with interest out of operations. A third way is by having the parent company increase its equity capital investment in the subsidiary. In turn the subsidiary could pay the parent dividends on the investment. These examples are illustrated in Figure 15.2 and help to show that there are many ways for multinational firms to generate internal cash for operations.

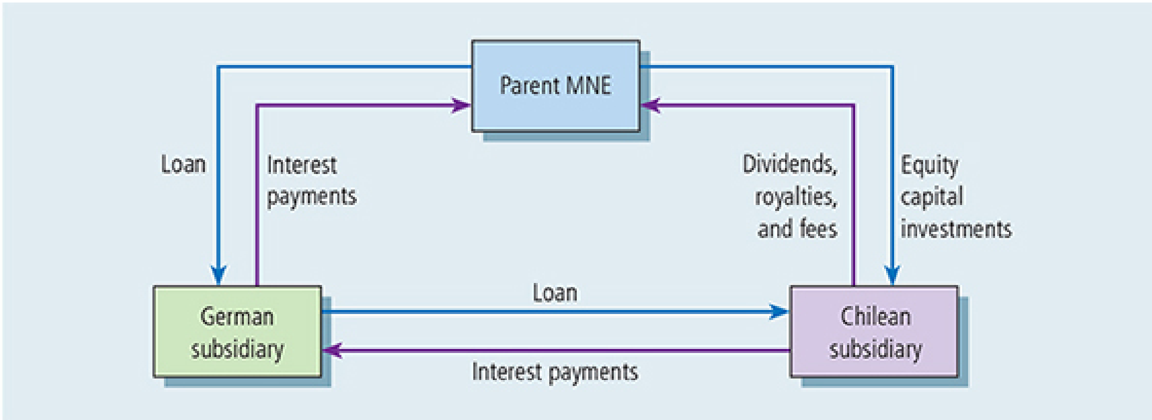

Figure 15.2 **Common examples of internal sources and flows of funds**

Which method is most likely to be used? The answer will depend on a number of factors, including government regulations regarding intercompany lending. For example, when tax rates are high for a profitable subsidiary, it is common to find those units willing to lend money at low rates of interest to other subsidiaries in the MNE that need funds to expand into growth markets. The logic behind this strategy is quite simple: the highly profitable unit does not need to charge a high interest rate because much of this interest earning will be lost to the high local taxes. Conversely, the subsidiary that is borrowing the money needs low interest rates so as to conserve its cash for expansion purposes. By shifting the money around in this fashion, the MNE is able to support expansion efforts, to minimise taxes, and to increase the sales potential of the subsidiaries. In an effort to prevent multinationals from taking advantage of such tax loopholes, in recent years some governments have changed their tax laws and established a minimum rate that can be charged on these intercompany loans.

Another area of concern is government limits on a parent company's ability to charge subsidiaries a licensing or royalty fee for the use of technology or to assess a management fee that covers the subsidiary's fair share of corporate overhead. When there are no government restrictions in these areas, the MNE has greater freedom in drawing funds from subsidiary

operations, thus providing the parent with a pool of money that can be used for other worldwide operations. The ways in which this is done are commonly referred to as funds positioning techniques.

Funds positioning techniques

Funds positioning techniques are strategies that are used to move monies from one multinational operation to another. While there are a variety of approaches, three of the most common are transfer pricing, use of tax havens and fronting loans.

Transfer pricing

A **transfer price** is an internal price that is set by a company in intrafirm trade, such as the price at which the Chilean subsidiary will purchase electric motors from the German subsidiary. An initial conclusion would be that the German firm will sell the motors at the same price as it would to any outside purchaser. A second conclusion is that the Chilean subsidiary will receive a discount because it is an intrafirm transaction and the parent will not allow its subsidiaries to profit at the expense of each other. However, both of these conclusions are incorrect when a transfer pricing strategy is employed. The final price will be determined by local regulations and will be set at a level that allows the MNE to achieve certain desired goals, such as to increase profit, to reduce costs and/or to move money among the subsidiaries.

Table 15.1 Shifting profits by transfer pricing

	Arm's-length price		Transfer price	
	Country A	Country B	Country A	Country B
Sales	$10,000 exports	$12,000	$12,000 exports	$12,000
Costs of sales	8,000	10,000	8,000	12,000
Profit	2,000	2,000	4,000	Nil
Tax rate (A: 40%, B: 50%)	800	1,000	1,600	Nil
Net profit	1,200	1,000	2,400	Nil

A good example is provided by a multinational that has a subsidiary located in Country A, which has a low corporate income tax and is selling goods to a subsidiary located in Country B, which has a high corporate income tax. If the transfer price is set carefully, it is possible to reallocate taxable income away from the highly taxed subsidiary to the subsidiary with the low tax rate. Table 15.1 provides an example by contrasting arm's-length pricing with transfer pricing. An **arm's-length price** is the price a buyer will pay for merchandise in a market under conditions of perfect competition. As seen in the table, it cost the subsidiary in Country A $8,000 for the goods it is selling to the subsidiary in Country B. Under an arm's-length price the seller is adding $2,000 for profit and selling the goods for $10,000. In turn the second subsidiary is selling these goods for $12,000. Thus both subsidiaries are making a profit of $2,000. As also seen in the table, the tax rate in Country A is 40 per cent, whereas in Country B it is 50 per cent. So the first subsidiary will have a net profit of $1,200, whereas the second subsidiary will net $1,000.

Under a transfer price arrangement, however, the objective is to maximise profits in the low-tax-rate country and to minimise them in the high-tax-rate country. In this case, as seen in Table 15.1, the first subsidiary sells the goods for $12,000, and after paying 40 per cent tax on the $4,000 profit, it ends up with a net profit of $2,400. The second subsidiary sells the goods for $12,000 and makes no profit. However, thanks to the transfer pricing strategy, the

multinational's overall profit is greater than it was with arm's-length pricing ($2,400 versus $2,200).

Note that taxes are not the only considerations. Import tariffs also influence the decision to use transfer pricing. If the importing country has high tariffs, the firm needs to consider whether a high or low transfer price will maximise after-tax, after-tariff profits.

One of the obvious benefits of transfer pricing is that it allows the multinational to reduce taxes. A second benefit is that the strategy lets the firm concentrate cash in specific locales such as with the first subsidiary, or to move funds away from a country facing significant exchange rate risk, or to reduce payment of import tariffs. One of the problems with transfer pricing is that the financial statements do not accurately reflect subsidiary performance because the profit margins are manipulated. A second problem is that the strategy may not encourage efficient performance by the seller in a low-tax jurisdiction, whose primary objective is to unload merchandise on the other subsidiary at a profit as high as can be justified.

In recent years, countries have been rewriting their tax codes to prevent arbitrary transfer pricing. In the United States, for example, the Internal Revenue Service (IRS) now asks multinationals to apply for an advanced determination ruling before establishing a transfer pricing policy. After the firm submits the request, the IRS will determine whether or not the policy is appropriate. The objective of the tax agency is to ensure that MNEs charge their overseas subsidiaries the same price for components and products as they charge independent third parties, thus effectively eliminating price manipulation for tax purposes. Because a large part (about one-third) of international trade in the early twenty-first century is intrafirm, transfer prices are a necessary aspect of much of international business.

Use of tax havens

A second funds positioning technique is the use of **tax havens**, which are low-tax countries that are hospitable to business (see Table 15.3). This strategy is typically used in conjunction with transfer pricing and involves a subsidiary selling its output at a very low cost to a subsidiary in a tax haven, which in turn sells the merchandise at a very high price to a third subsidiary. Table 15.2 provides an example, which is similar to that in Table 15.1, except that the sales are now routed through a subsidiary located in a tax haven, Country B, where no tax is paid at all. The result of the example in the table is a net profit of $4,000. This is greater than that illustrated in Table 15.1, where a simple case of transfer pricing was employed. For more on the matter of tax havens, see the case **International Business Strategy in Action: Worldwide tax havens**.

Fronting loans

A **fronting loan** is a funds positioning strategy that involves having a third party manage the loan. For example, if a US multinational decided to set up operations in China, the MNE might be concerned with the political risk that accompanies such a decision. Is it possible that the government might expropriate the subsidiary's assets, including all the cash on hand? In an effort to protect its investments, the parent company could deposit funds with a major international bank that has strong ties to China and is on good terms with the government. In turn the subsidiary would apply for a loan with this bank and the multinational company's deposit would be given to the subsidiary in the form of a loan. It is highly unlikely that the Chinese government would expropriate the subsidiary and endanger the loan or its relationship with the international bank. Thus the MNE has successfully positioned its funds.

Funds positioning strategies are important in moving money around a multinational, as well as in helping the MNE to cope with political and legal

roadblocks that stand in the way of such action. However, an internally operated netting process that controls the flow of funds and ensures that bills are paid promptly always complements these strategies. This process is often collectively referred to as multilateral netting.

Multilateral netting

When subsidiaries do business with each other, each may owe money to the others and in turn be owed money by them. Figure 15.3 provides an example of four subsidiaries that have both amounts due and amounts payable from each of the others. Over time, of course, these obligations will be resolved by the individual subsidiaries. In an effort to make the process more efficient, however, many multinationals have now set up **clearing accounts** in a certain location and assigned the manager at this location the authority to make the transfers that are necessary to pay intracompany subsidiary obligations. This process of multilateral netting, which involves a determination of the net amount of money owed to subsidiaries through multilateral transactions, begins with a computation of the amounts owed to each. Table 15.4, which has been constructed based on the information in Figure 15.3, shows these net positions. Based on this information, those that owe money are required to transfer it to a centralised clearing account (see Figure 15.4), whereas those that are owed money are paid from this central account.

Table 15.2 Transfer pricing through tax havens

	Country A subsidiary	Country B subsidiary (tax haven)	Country C subsidiary
Sales	$8,000 exports	$12,000 exports	$12,000
Costs of sales	8,000	8,000	12,000
Profit	—	—	—
Tax rate (A: 40%, B: 0%, C: 50%)	—	—	—
Net profit	0	4,000	0

Table 15.3 The world's top 50 tax havens based on the Financial Secrecy Index (FSI), 2018

Rank	Jurisdiction	FSI value[4]	FSI share[5]	Secrecy score[2]	Global Scale weight[3]
1	Switzerland	1589.57	5.01%	76.45	4.50%
2	USA	1298.47	4.09%	59.83	22.30%
3	Cayman Islands[1]	1267.68	4.00%	72.28	3.79%
4	Hong Kong	1243.68	3.92%	71.05	4.17%
5	Singapore	1081.98	3.41%	67.13	4.58%
6	Luxembourg	975.92	3.08%	58.20	12.13%
7	Germany	768.95	2.42%	59.10	5.17%
8	Taiwan	743.38	2.34%	75.75	0.50%
9	UAE (Dubai)	661.15	2.08%	83.85	0.14%
10	Guernsey[1]	658.92	2.08%	72.45	0.52%
11	Lebanon	644.41	2.03%	72.03	0.01
12	Panama	625.84	1.97%	76.63	0.27%
13	Japan	623.92	1.97%	60.50	2.24%
14	Netherlands	598.81	1.89%	66.03	0.90%
15	Thailand	550.60	1.74%	79.88	0.13%
16	British Virgin Islands[1]	502.76	1.59%	68.65	0.38%
17	Bahrain	490.71	1.55%	77.80	0.11%
18	Jersey[1]	438.22	1.38%	65.45	0.38%
19	Bahamas	429.00	1.35%	84.50	0.04%
20	Malta	426.31	1.34%	60.53	0.71%
21	Canada	425.84	1.34%	54.75	1.75%
22	Macao	424.92	1.34%	68.25	0.24%
23	United Kingdom[1]	423.76	1.34%	42.35	17.37%
24	Cyprus	404.44	1.28%	61.25	0.55%
25	France	404.18	1.27%	51.65	2.52%
26	Ireland	387.94	1.22%	50.65	2.66%
27	Kenya	378.35	1.19%	80.05	0.04%
28	China	372.58	1.17%	60.08	0.51%
29	Russia	361.16	1.14%	63.98	0.26%
30	Turkey	353.89	1.12%	67.98	0.14%
31	Malaysia (Labuan)	335.11	1.06%	71.93	0.07%
32	India	316.62	1.00%	51.90	1.16%
33	South Korea	314.06	0.99%	59.03	0.36%
34	Israel	313.55	0.99%	63.25	0.19%
35	Austria	310.41	0.98%	55.90	0.56%
36	Bermuda[1]	281.83	0.89%	73.05	0.04%
37	Saudi Arabia	278.58	0.88%	69.88	0.05%
38	Liberia	277.29	0.87%	79.70	0.02%
39	Marshall Islands	275.29	0.87%	72.93	0.04%
40	Philippines	269.81	0.85%	65.38	0.09%
41	Italy	254.14	0.80%	49.48	0.92%
42	Isle of Man[1]	248.68	0.78%	63.58	0.09%
43	Ukraine	246.25	0.78%	69.15	0.04%
44	Australia	244.36	0.77%	51.15	0.61%
45	Norway	242.85	0.77%	51.58	0.55%
46	Liechtenstein	240.86	0.76%	78.28	0.01%
47	Romania	232.30	0.73%	65.53	0.06%
48	Barbados	230.95	0.73%	73.85	0.02%
49	Mauritius	223.47	0.70%	72.35	0.02%
50	South Africa	216.44	0.68%	56.10	0.18%

Source: Tax Justice Network (2018) Financial Secrecy Index (www.financialsecrecyindex.com).

Notes:

(1) These are Overseas Territories (OTs) and Crown Dependencies (CDs) where the Queen is head of state; powers to appoint key government officials rest with the British Crown; laws must be approved in London.

(2) The Secrecy Scores are calculated based on 20 indicators in areas including: Ownership registration, Legal Entity Transparency, Integrity of tax and financial regulation, International Standards and Cooperation.

(3) The Global Scale Weight represent a jurisdiction's share in global financial services exports.

(4) The FSI Value is calculated by multiplying the cube of the Secrecy Score with the cube root of the Global Scale Weight. The final result is divided through by one hundred for presentational clarity.

(5) The FSI Share is calculated by summing up all FSI Values, and then dividing each countries FSI Value by the total sum, expressed in percentages. For a full explanation of the methodology and data sources, see www.financialsecrecyindex.com/PDF/FSI-Methodology.pdf

Table 15.4 Net cash positions of subsidiaries

Subsidiary	Total receivables	Total payables	Net positions
German	$300,000	$225,000	$75,000
Chilean	125,000	150,000	225,000
Japanese	200,000	275,000	275,000
Mexican	225,000	200,000	25,000

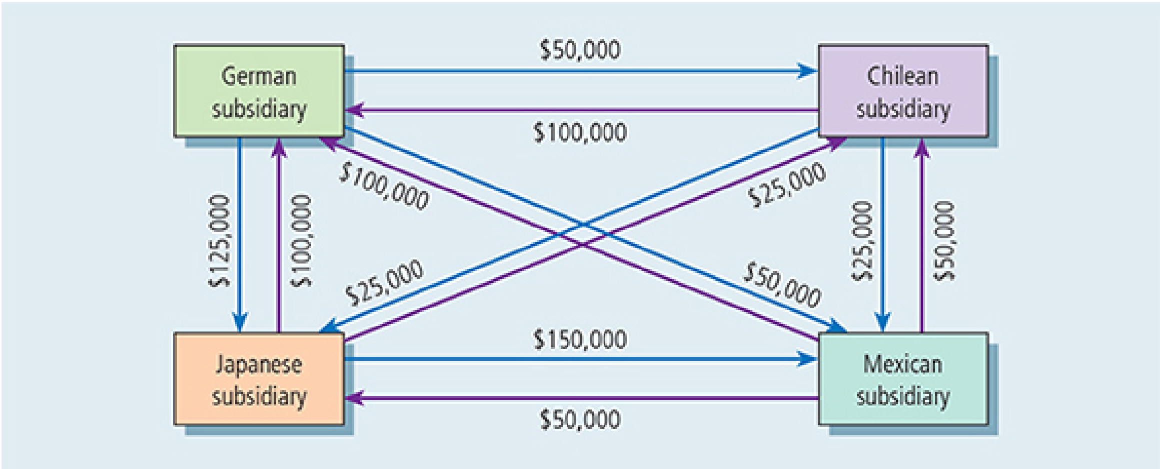

Figure 15.3 **Multilateral dollar flows between subsidiaries**

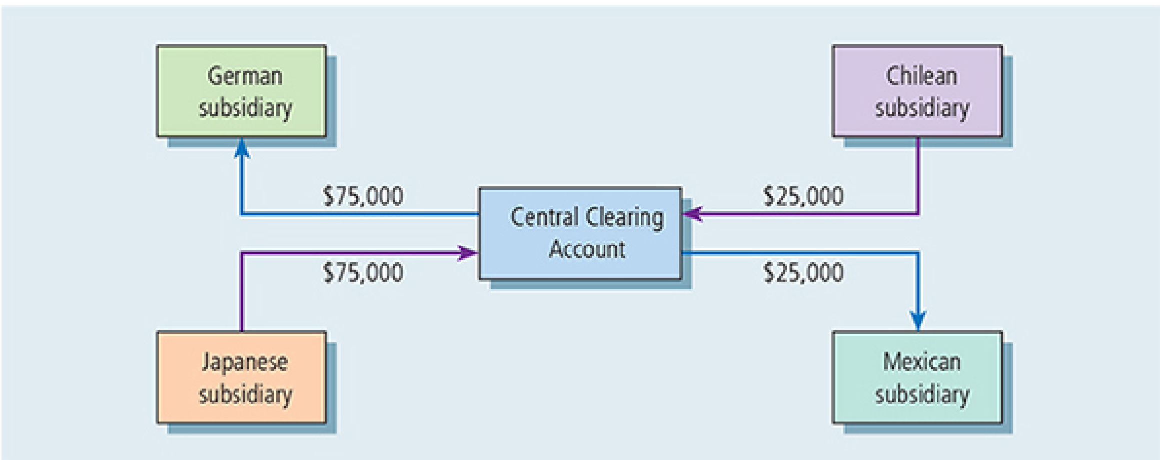

Figure 15.4 **Centralised netting process in action**

The clearing account manager is responsible for seeing that this process occurs quickly and correctly. Typically, this manager will receive monthly transaction information from all the subsidiaries and will use these data to determine the net position of each unit. The manager will then see that the necessary transfers are made. These transfers usually take place in the currency of the payer, so the German subsidiary will pay its obligation in euros, whereas the Mexican subsidiary will pay in pesos. The clearing account manager's staff will handle the process.

There are a number of reasons that multilateral netting has become popular. One advantage is that it helps the parent company to ensure that

financial interactions between the units are quickly brought to completion. If bills are allowed to be outstanding for months at a time, it can result in the other units not wanting to do business with slow-paying subsidiaries. Netting helps to reduce the likelihood of such problems. A second advantage is that those units that are owed money have faster access to their funds. A third advantage is that the parent company knows which subsidiaries are amassing large amounts of cash and can tap these sources if necessary to support activities in other locales. A fourth advantage is that the cost of converting foreign exchange is minimised because the central clearing account manager can convert large amounts at the same time.

There are also some problems associated with multilateral netting. One is that many governments place controls on these operations by allowing them only for trade transactions. So the MNE’s ability to use netting for moving funds can be limited. A second problem is that in other cases governments have required that payment for imports be delayed until these goods clear customs, thus slowing down the netting process by as much as 60 to 90 days. A third is getting local subsidiary managers to cooperate and keep the central clearing account manager fully apprised of all transactions affecting this process. Sometimes there is a reluctance to cooperate on the part of those managers whose cash outflows are substantially larger than their inflows. Under a netting process they can no longer delay payments for three or four months while working to reverse the flow and to pay their bills out of current earnings.

INTERNATIONAL BUSINESS STRATEGY IN ACTION

Worldwide tax havens

What do Switzerland, the Bahamas, Monaco and Andorra have in common? By some definition, they are all considered to be tax havens. In general, a tax haven is a country or a jurisdiction that allows individuals or corporations to set up a subsidiary and to avoid paying taxes in their country of residence, thus depriving their home governments of some tax revenues that are used to provide government services.

As of 2018, an estimated $21 trillion to $32 trillion of private financial wealth is located, untaxed or lightly taxed, in tax havens or ‘secrecy jurisdictions’ across the world. African countries as a group are thought to have lost over $1 trillion in ‘capital flight’ since the 1970s. Reportedly, loans issued to African governments from external lenders totalled $460 billion between 2006 and 2017. Therefore, Africa is a major net creditor to the rest of world because of these practices.

One of the main reasons for the creation of tax havens in the first place was the lack of any single, overarching international tax standard. Individual governments have different tax policies, so MNEs have an incentive to deploy their financial assets across their worldwide network of subsidiaries in order to minimise taxation. It would not be possible for MNEs to do this if there were a common unitary world tax system. The MNEs are reacting to the lack of a global standard in government tax policy, yet governments then blame them for using legal tax havens to reduce overall taxes paid.

Each tax haven jurisdiction has its own sets of laws on taxation and levels of transparency. Tax havens are also sometimes accused by governments and NGOs such as Oxfam as being a means for money laundering and for hiding the proceeds of criminal activity, including political corruption, illicit arms dealing and drug trafficking. Governments have come together more recently to reduce the potential for tax havens to be used for these purposes, but accurate data to map trends in the criminal exploitation of tax havens is not readily available. The United Nations has also actively been trying to curb the use of tax havens for money laundering.

The OECD lists a number of factors used to identify a tax haven. Among these, a tax haven is a country or jurisdiction that: (1) imposes no or nominal taxes and is used by foreigners to escape taxes in their own countries (this includes ‘ring-fencing’ jurisdictions that reserve preferential

treatment to foreigners, thus shielding the country from tax avoidance by its own residents); (2) has laws or administrative practices that prevent the exchange of information with other governments on taxpayers benefiting from low taxation; (3) lacks transparency; and (4) does not require substantial productive operations in the country, suggesting policies geared to attracting income only on a preferential tax basis. Of all these factors, only the first one is necessary for the identification of a tax haven.

The Financial Secrecy Index (FSI) ranks countries according to the secrecy and the scale of their activities and claims to be a politically neutral ranking tool. Table 15.3 provides the latest ranking from 2018 data. The aim of the Tax Justice Network which developed the ranking is to improve our understanding of global financial secrecy, tax havens and illicit financial flows.

Source: Trevor Smith/Alamy Stock Photo

In recent years, the OECD has been pressuring countries and jurisdictions to reverse what it calls harmful tax competition and lack of transparency. The EU has also challenged the use of unfair tax competition by US exporters in the World Trade Organization and won. Under US law, US exporters could set up a sales operation in an offshore tax haven and avoid paying taxes on the proceeds of this business. The British and French governments have also each targeted their own tax haven jurisdictions, the British challenging the Channel Islands and Isle of Man offshore tax havens.

Reluctantly, many of these countries have responded to OECD pressures and reformed their policies. The Channel Islands and the Cayman Islands both have anti-money-laundering legislation.

Under pressure from the French government, Monaco also signed an agreement to prevent money laundering, increase transparency and remove some tax concessions.

Yet the total eradication of tax havens will not come without confrontation. For one, tax havens and their financial institutions depend heavily on these deposits. The Bahamas, which considers itself a major international financial hub, can foresee a tremendous loss of income, especially if other countries, including Switzerland and Luxembourg, are not ready to implement the same policies. The Bahamas has argued that the OECD is using a two-tier system, cooperatively designing legislation with its member countries and then imposing this regime on smaller, less developed, non-member countries.

Since the financial crash of 2008 efforts to improve transparency and regulate tax havens have gathered momentum. In 2015 a number of national governments launched investigations into the activities of HSBC's private bank in Switzerland, which was accused of helping clients evade tax payments through a range of illegal mechanisms. This gave added momentum to steps that the Swiss government was already making to change its status as the world's largest tax haven. Other tax havens including Singapore, Dubai and Monaco have been following suit and promised to open their financial records to scrutiny by tax authorities from around the world. However, in 2017, Switzerland decided to delay the implementation of automatic information exchange. Moreover, Kenya is a relatively new country to be added on the FSI list. Ranked as 27, but with a secrecy score of 80, it shows that even Kenya, which is not commonly associated with classic secrecy havens, can quickly become an important player.

Websites: www.oecd.org; www.oxfam.org; www.financialsecrecyindex.com; https://www.acfcs.org/news/385075/U.S.-jumps-to-No.-2-Switzerland-retains-top-spot-in-international-secrecy-index-in-race-to-bottom.htm; https://www.publicfinanceinternational.org/news/2018/10/african-governments-external-debt-rises-dramatically-says-campaign-group

Sources: 'A progress report on the jurisdictions surveyed by OECD Global Forum in implementing the internationally agreed tax standards, progress made as at 4 January 2011' (original progress report 2 April 2009), OECD, www.oecd.org; Vanessa Houlder, 'The tax havens hidden in plain sight', *Financial Times*, 13 February 2015.

Multilateral netting can help an MNE to ensure that inter-subsidiary accounts are balanced, and the process is extremely useful in assisting the parent company in managing global cash flows. However, there is an inherent problem in this process that requires special attention and which netting cannot resolve: foreign exchange risk as typified by the fluctuating value of international currencies. This risk is particularly important when MNEs do business with buyers who are paying in weak currencies. In dealing with this dilemma, MNEs often formulate a foreign exchange risk management strategy.

Managing cash

Consider a multinational firm such as Nestlé (based in Switzerland) whose network of affiliates extends around the world. Each affiliate has its own customers and suppliers, as well as financial ties to the rest of the company. Viewing the company as a single unit for purposes of cash management can yield far better results than would be obtained if each affiliate managed its cash independently. For example, much less foreign exchange protection is generally needed if all of the affiliates are evaluated together than if each affiliate **hedges** its own position. The French subsidiary may have a large number of accounts payable in euros that can be hedged simply by consolidating the German affiliate's excess cash, which is also in euros. Similarly, the Canadian subsidiary may possess a large amount of Canadian dollar assets that can be hedged by having the US company contract some liabilities (for example, by purchasing equipment or taking out loans) denominated in Canadian dollars. The whole company may coordinate its borrowing efforts through the British subsidiary, which uses the London eurocurrency market.

Centralised cash management offers five kinds of potential gains to the MNE:

1. By pooling the cash holdings of affiliates where possible, the MNE can hold a smaller total amount of cash, thus reducing its financing needs.
2. By centralising cash management, it can have one group of people specialise in the performance of this task, thus achieving better decisions and economies of scale.
3. By reducing the amount of cash in any one affiliate, it can reduce country risks as well as financial costs.
4. As noted previously, it can net out intracompany accounts when there are multiple payables and receivables among affiliates, thus reducing the amount of money actually transferred among affiliates.
5. Its central cash management group can ensure that cash management decisions aim at corporate goals rather than the goals of individual affiliates when these might conflict.

The first kind of gain results simply from better use of the cash held by the firm. If each affiliate holds enough cash to meet its transactions needs, precautionary needs and speculative needs (following the Keynesian categories of money demand), far more cash is likely to be held than is needed *company-wide*. A domestic company centralises the cash management function at one location (usually the home office), and an MNE can do the same. The key difference between the two is that the MNE is often restricted in its ability to shift funds among affiliates internationally; thus, less centralisation is possible at the MNE level. Any reduction in cash holdings, however, enables the firm to reduce its financing needs, thus lowering costs.

The second kind of gain relates to the development of management skills. By centralising the cash management function, even if funds are left in the affiliates for the most part, the firm can utilise the skills of a specialised group

of cash managers. Gains from this group's decision making should include economies of scale in borrowing, since the group can borrow to meet the entire company's needs and then distribute funds to affiliates as required. Also, the group should develop detailed knowledge of financial opportunities worldwide, thus enabling the firm to borrow at lower cost or lower risk than firms lacking such expertise.

If the MNE reduces its total assets through centralised cash management, it also reduces both its exchange risk and its country risk, in that fewer assets are at risk worldwide. The country risk does not change, but the exposure of the company to that risk decreases. Country risk may also be hedged or transferred by the decision-makers in the cash management group, who have greater access to protection tools than do managers in any one affiliate.

The fourth kind of benefit, from multilateral netting of accounts, is primarily cost savings from the reduced need to transfer funds between affiliates.

The fifth kind of gain from centralised cash management relates to business strategy. Placing the cash management function in one location, either at the home office or at a location closely monitored by the home office, makes better control possible. In this way, the firm can ensure that cash management decisions are made to meet global corporate needs rather than to improve an affiliate's position, possibly at the expense of the rest of the company. This is especially true with respect to hedging, which should be decided at the corporate level, since virtually every affiliate is likely to have assets or liabilities in another currency that are partially or totally hedged by balance sheet items of other subsidiaries.

While centralised cash management offers obvious and potentially very large benefits, it also presents some problems. Most importantly, if freedom to manage cash is taken away from the affiliate manager, some of the affiliate's ability to improve its performance is also removed. The evaluation of each

affiliate must recognise this point. (This idea is discussed further in the section on controls.)

Another problem with internationally centralised cash management arises when national rules restrict financial transfers into or out of some countries. Virtually all less developed countries and many developed ones limit funds outflows through exchange controls or taxation. Some countries specifically disallow international netting of payments. Because of such restrictions, international cash management today requires a great deal of knowledge about national financial constraints and often requires a decentralised strategy of funds transfers due to these constraints.

The whole idea of international funds transfer and management is a major opportunity for firms that have operations in multiple countries. Not only can transfer pricing, multilateral netting and so on be used to move funds as needed in the firm, but other policies such as dividend remittances, payment of royalties and fees and intracompany loans are among the many alternatives that can be used to optimise the firm's overall financial situation.

INTERNATIONAL BUSINESS STRATEGY IN ACTION

Sovereign wealth funds

In terms of international financial management, a recent development illustrates the tensions between the workings of financial markets and the sovereignty of nations. Mainly due to its large and persistent balance of trade deficit, the United States has long been a destination for inward financial flows. Basically, the US trade deficit has to be balanced by a surplus on its capital (monetary) accounts. Another way of saying this is that, as Americans consume more in imports than they export, leading to a trade deficit, it is necessary to sell US financial assets to foreigners to balance the books. The end result of these financial capital inflows is that foreigners own more American assets.

For many years, foreigners bought US Treasury bonds and other financial assets. However, as the value of the US dollar decreased in 2007 and 2008, the yields on US financial investments also started to fall. Financial assets denominated in US dollars became less valuable compared to assets in other currencies such as the euro. Even the Canadian dollar was worth more than a US dollar in late 2007.

The result of the falling US dollar was that foreigners switched from financial investments into the US stock market. Equity ownership of US firms became a substitute for US bonds for foreigners. Many US firms welcomed such foreign investment, even as it diluted American ownership of their companies. For example, some US financial institutions, such as Citigroup, Merrill Lynch and Morgan Stanley, were bailed out by foreign private equity funds in early 2008. However, this has raised issues of sovereignty as the richest private equity funds are owned by governments from the Middle East and China. They are called sovereign wealth funds.

For example, one of the world's richest sovereign wealth funds is owned by the government of Dubai. Some time ago the takeover of some US ports by Dubai Ports was criticised by Senator Hillary Clinton and many of her colleagues in the US Congress. President George W. Bush was forced to reopen the process by which Dubai Ports had been allowed to take over US ports. Senator Clinton argued that US ports should not be foreign owned, but seemed to have forgotten that the firm was already foreign owned, by a British company, P&O. What she and her congressional colleagues

really objected to was that Dubai Ports was a Middle Eastern government-owned financial company, against which discriminatory measures should be used.

Ultimately the US government can discriminate against foreign investors on the grounds of national security. In the case of US ports there is some logic to such discrimination, especially in a post-9/11 world. However, it is difficult to apply this logic of national security to many of the protectionist arguments raised by labour groups and others opposed to foreign investment. The confusion arises because the large state-run private equity funds of the Middle East and China are seen as instruments of their governments. They are not seen as purely financial investment houses, although they operate in world financial markets in the same way as the banks and financial institutions of Western economies.

The control of strategic entities in the United States will continue to be controversial. The Dubai Ports case sparked discussion of whether any of the 360 US ports should be allowed to be operated by foreign entities. Three out of five terminals in New York and New Jersey, and 80 per cent of the Port of Los Angeles, are now being operated by foreign firms. At the time of the controversy, only about 5 per cent of the approximately 26,000 containers arriving daily at the US coasts were inspected by the US government, leaving the responsibility of screening the rest to companies that own and operate the ports. One of these companies is Denmark-based Maersk Group, vertically integrating into port management from its core business of vessel operation. In operating terminals in 12 different ports across the United States, the company plays a part in US national security efforts.

This issue is also relevant in Europe, where European firms such as Swiss bank UBS received funds from the Singapore Investment Corporation (GIC). The British bank Barclays also received investments from Temasek of Singapore.

The world's largest sovereign wealth funds are reported in Table 15.5. The largest sovereign wealth fund is Norway's Government Pension Fund – Global founded in 1990, while Singapore's Temasek was set up in 1974. Ranked third in Table 15.5, Abu Dhabi's Investment Authority was set up just two years after Singapore's Temasek, and primarily manages UAE's excess oil reserves, which is reportedly worth $875 billion. Impressively, Abu Dhabi's Investment portfolio has been growing by approximately 7 per cent every year from 2015 to 2017. The China Investment Corporation, a much newer fund, invested $3 billion in US buyout firm Blackstone. This is ranked as the second largest wealth fund in Table 15.5, and by the start of 2018, its total assets had increased to over $941.4 billion. It is not clear how the issue of sovereign equity funds will be resolved. At a macro-economic level it is necessary for world financial and trade imbalances to be reconciled. As long as the United States has a large trade deficit there will need to be inward flows of foreign investment. If a large proportion of these inward flows are from private equity funds, then there is little that the United States can do to avoid this.

Sources: Financial Times, 24 January 2008; Mimi Hall, Bill Nichols and Sue Kirchhoff, 'Security issues go beyond ports flap', *USA Today*, 23 February 2006; Jessica Holzer, 'Dubai's Olive Branch', *Forbes*, 3 October 2006; David Shuster, 'Who owns the United States ports?' MSNBC, 22 February 2006; www.maersk.com; Sovereign Wealth Fund Institute, http://www.swfinstitute.org/sovereign-wealth-fund-rankings/ (November 2015); https://www.adia.ae/En/pr/2017/ui/downloads/ADIA_Annual_report_2017.pdf; http://www.china-inv.cn/chinainven/Media/2018-07/1001376.shtml.

Table 15.5 Largest sovereign wealth funds by assets under management, 2018

Rank	Sovereign wealth fund	Total assets	Region
1	Norway Government Pension Fund Global	$989,934	Europe
2	China Investment Corporation	$941,417	Asia
3	Abu Dhabi Investment Authority	$696,660	Middle East
4	Kuwait Investment Authority	$592,000	Middle East
5	Hong Kong Monetary Authority Investment Portfolio	$509,353	Asia
6	SAFE Investment Company	$439,836	Asia
7	GIC Private Limited	$390,000	Asia
8	Temasek Holdings	$374,896	Asia
9	National Council for Social Security Fund	$341,354	Asia
10	Qatar Investment Authority	$320,000	Middle East
11	Public Investment Fund	< $320,000	Middle East
12	Investment Corporation of Dubai	< $320,000	Middle East
13	Mubadala Investment Company	< $320,000	Middle East
14	Korea Investment Corporation	< $320,000	Asia
15	Future Fund	< $320,000	Australia and Pacific
16	National Development Fund of Iran	< $320,000	Middle East
17	Alberta Investment Management Corporation	< $320,000	North America
18	Samruk-Kazyna	< $320,000	Asia
19	National Welfare Fund	< $320,000	Europe
20	Alaska Permanent Fund Corporation	< $320,000	North America

Source: Sovereign Wealth Institute, https://www.swfinstitute.org/fund-rankings/sovereign-wealth-fund (updated April 2019).

EXCHANGE RISK MANAGEMENT

We have discussed exchange risk primarily in relation to *transactions* denominated in foreign currency. In addition, exchange risk exists in the translation of financial statements and, in principle, for future, so-far unspecified activities of the firm. Three kinds of exchange risk should be differentiated: (1) transaction risk; (2) translation risk; and (3) economic risk. Each kind of risk is important to the MNE, and each leads to somewhat different conclusions for hedging strategies.

Transaction risk

When a specific contracted asset or liability is denominated in a foreign currency, it is subject to **transaction risk**, or the risk of an unexpected change in its home-currency value during the time to maturity. Accounts payable and receivable, loans and bank deposits denominated in foreign currencies are examples of items that are subject to such exchange risk. Each foreign currency transaction can be hedged (or not) with some offsetting transaction in the same currency and with the same maturity. This topic was discussed in Chapter 7, and a new example is presented at the end of this section.

Translation risk

Translation risk, or accounting risk, is the risk of value changes in foreign currency assets and liabilities on the balance sheet, whether or not the transactions occur during the accounting period. For example, the plant and equipment of foreign subsidiaries is subject to valuation change even if no purchase or sale of such items takes place during the accounting period. Because balance sheet information is reported in most countries to securities

regulators and in published financial statements, valuation changes in the foreign operations of multinational firms become public knowledge. Loss in the value of foreign currency assets, regardless of its impact on company earnings, may negatively affect investors' perceptions of a firm. To avoid the appearance of weakness due to the devaluation of foreign assets, firms often try to hedge their balance sheets through financial contracts (such as forward contracts or money market hedges).

A good example of this exposure for a US MNE is when the currency of a local country weakens in relation to the dollar. For example, if the Chilean peso declined by 10 per cent against the dollar, the value of the Chilean subsidiary's peso account at the local bank would also decline when translated into dollars in the **consolidation** process. If the company had the equivalent of $100,000 (US) on deposit, this account would now be worth $90,000 in translation and consolidation. Of course, this decline would not affect the number of pesos on deposit, and the local purchasing power of these pesos, at least in the short run, would remain the same. However, the decline would negatively affect the subsidiary's ability to purchase imports from countries with strong currencies since it would now take more pesos than before to buy these goods.

Conclusions as to the desirability of **balance sheet hedging** are ambiguous. On the one hand, since investor decisions may be based on valuation changes in foreign currency assets, the firm should hedge to avoid investor preoccupation with such changes. On the other hand, since the valuation of foreign currency assets may not affect the economic viability of the project, it would be a waste of effort for the firm to deal with such changes.

Economic risk

Economic risk is the risk of unexpected changes in future cash flows from foreign operations (and from activities denominated in foreign currencies, wherever they occur). Such risk is most important to the firm, since future cash flows are the basis for the firm's value. Unfortunately for the manager, it is not possible to know with certainty the full set of future cash flows that will occur. Thus, a hedging strategy cannot be perfectly matched with such cash flows. To deal with economic risk, the firm may choose to follow a generalised strategy of hedging transactions when they are contracted and trying to balance foreign currency assets and liabilities as they appear on the balance sheet. Or the firm may choose not to hedge at all, on the assumption that future currency fluctuation will be approximately offset by price changes in each country (that is, purchasing power parity will approximately hold). Despite the inherent difficulty of predicting future foreign exchange exposures, ultimately the firm should be concerned about economic (foreign exchange) risk as the key variable in exchange risk management.

Consider the economic risk involved with a subsidiary's assets. If the value of the local currency strengthens, the sale of inventory will generate larger dollar profits. However, would it be wiser to lower the price, to take less profit per item but to generate more demand? Similarly, would it be wise now to sell fixed assets such as buildings or factories and then to lease them back from the purchaser? MNE managers need to estimate how the value of all kinds of fixed assets, from factory buildings in Bangalore to office space in London, is likely to change in the future and change asset strategy accordingly.

Another example of economic exposure is the risk that companies take when selling to a country with a weakening currency. In this case many MNEs have sought to increase their own production efficiency, lower their costs, and continue to generate acceptable profit. Firms such as Honda, Nissan and BMW have complemented this strategy by setting up operations in the

United States, their largest international market. In the process, the firms have reduced their economic exposure.

In fact, all three kinds of foreign exchange risk play important parts in the management of an international firm. No single hedging strategy can cover them all, so the MNE manager must devise plans for dealing with each. Fortunately, both transaction and economic risk deal with future cash flows; thus, the management of these two kinds of risk can be combined fairly readily. For example, the firm can hedge all occasional exports denominated in foreign currencies and seek local-currency financing for the entire production of its foreign affiliates. Then, if it does not employ balance sheet hedging (as suggested earlier), it can follow a consistent and simple hedging strategy. Judging from the immense volume of material dealing with corporate foreign exchange management strategies, it is safe to say that MNEs generally do *not* follow such simple strategies. Instead, they combine some hedging with some speculation in an effort to maximise their results from foreign exchange dealings. Table 15.6 lists a range of exchange risk hedging techniques that can be used to deal with one or more of these exchange risk categories.

Table 15.6 Exchange risk hedging techniques*

To hedge an exposed liability	To hedge an exposed asset
Buy foreign exchange in the forward market	Sell foreign exchange in the forward market
Buy foreign exchange in the futures market	Sell foreign exchange in the futures market
Buy foreign exchange call options	Buy foreign exchange put options
Invest/deposit in a foreign exchange instrument	Borrow in a foreign exchange instrument
Incur accounts receivable in foreign exchange	Incur accounts payable in foreign exchange
Swap liabilities with another firm	Swap assets with another firm
Obtain any other foreign exchange asset	Obtain any other foreign exchange liability

*These techniques assume no expectation about the direction of exchange rate change. If devaluation is expected, then creation of a net liability position is attractive, and vice versa for expected revaluation. In

each instance, the hedge must produce an equal-value asset (liability) in the same currency with equal maturity to offset the exposed liability (asset).

Active learning check

Review your answer to Active Learning Case question 2 and make any changes you like. Then compare your answer to the one below.

2 How is Siemens exposed to exchange rate risks and what kinds of hedging strategies could it employ to mitigate these risks?

As a major MNE, Siemens is exposed to all three of the main types of exchange rate risk, namely: transaction risk, translation risk and economic risk. It is continually moving goods, services and funds across borders, so any changes in the exchange rates between countries will have an effect on its finances. Given its main operating regions, the changing value of the euro against the US dollar and the Chinese renminbi are likely to be particularly important. Because it has manufacturing assets distributed around the world, it is subject to translation risk. This means that its balance sheet assets and liabilities (plant and equipment) change in value according to shifts in exchange rates, even if none of these are bought or sold in the accounting period. Siemens should, and probably does, employ most if not all of the hedging strategies listed in Table 15.6.

An example of exchange risk management

Consider the situation faced by a US-based firm such as American Express Company (Amex) when its subsidiary in the UK reports the purchase of £5 million of office equipment (mainly furniture and computer terminals) for the subsidiary's tourist service offices throughout that country. This equipment is to be paid for in 180 days in British pounds. The strategies for dealing with exchange risk in this transaction depend on the whole firm's position in British pounds. The problem can be analysed as follows.

First, if American Express already has an existing asset exposure in the UK due to its subsidiary's ongoing activities, that position may partially or wholly cover the new transaction. In other words, if American Express (UK)

has a balance sheet that shows net sterling (pound) assets, typically because foreign subsidiaries have some dollar liabilities, the new account payable may partially offset that asset exposure.

Second, the same results may occur even if the British subsidiary has been operated to cover ongoing exchange risk in the UK. In the event that American Express has placed funds in euro–British pound deposits in one of its other subsidiaries (for example, in France or Germany), the new account payable may offset the existing exposure. *Note that the exposure is still not covered unless the maturity of the existing asset matches the six-month maturity of the new liability*.

Third, American Express can look for a financial hedging technique to avoid the exchange risk. For example, some new asset such as a bank deposit or short-term security could be purchased with a maturity of 180 days and a value of £5 million. Or a forward contract could be arranged with a bank to sell dollars and buy pounds in 180 days. Through the London International Financial Futures Exchange (LIFFE) or through one of the US futures exchanges, American Express could arrange a futures contract or **currency option** contract to hedge the account payable. The alternatives are numerous, but the basic goal is to find a British pound asset that matures in 180 days, worth £5 million, to hedge the new liability that calls for a cash outflow of £5 million in 180 days.

The following table lists relevant financial information, with realistic exchange rate assumptions, for American Express to make this hedging decision.

Spot exchange rate	US$1.57680/£1
180-day forward exchange rate	US$1.57350/£1
180-day LIBOR rate in pounds is 1.06375%	2.1275%/year
180-day LIBOR rate in dollars is 0.45681%	0.91362%/year
6-month sterling call option (to buy) strike price:	
The options cost US $875 per contract at the CME, with £31,250 per contract	US$1.5840/£1

For this option, the premium is US $0.0072/£	
6-month sterling futures contract rate:	
The futures contracts have £62,500 per contract	US$1.5800/£1

American Express can use this information to evaluate various financial hedges for the sterling account payable. First, the firm can use a simple forward contract to hedge the exposure. A forward exchange contract to buy British pounds would cost about US$7.8675 million in six months, as follows:

$$£5,000,000 \times US\$1.57350/£ = US\$7,867,500$$

This forward exchange contract completely hedges the account payable, because it will result in receipt from the bank of £5 million in 180 days, which will be used to pay the supplier of office equipment.

A second alternative is called 'money market hedging'. The first step is to place funds now into a pound-denominated investment that matures in six months. The choice shown above is a eurosterling account that pays 2.1275 per cent per year for the six-month period. The dollar value of pounds for American Express to buy today can be calculated by discounting the future pounds that are needed to a present value of pounds that must be deposited today to achieve that sum in six months. The calculations are as follows:

$$£5,000,000/(1.043003) = £4,793,850.17$$

This first step shows that the interest earned in the eurosterling deposit for 180 days will be 1.06375 per cent (that is, 2.1275%/2) and that £4,793,850.17 must be deposited today to reach the value needed to pay the account payable. Next, the dollars that must be used today to buy these pounds is:

$$£4,793,850.17 \times US\$1.57680/£1 = US\$7,558,942.95$$

The hedging cost is lower for this alternative, since the funds must be paid *now* rather than in 180 days. To compare the two choices, they must be placed in the same time period. This requires discounting the forward contract value

using the relevant discount rate, which would be a deposit interest rate in dollars for the same time period:

$$US\$7{,}867{,}500/(1.018421) = US\$7{,}725{,}194.28$$

The discount amount (1.018421) is the implicit return to depositing funds in a eurodollar account (comparable to the europound deposit) for six months at 0.91362 per cent per year. This results in a lower cost of hedging in the money market hedging (US$166,251.79).

A third alternative is to use a futures contract hedge in the LIFFE or the Chicago Mercantile Exchange (CME). Using the CME's quotes, we see that American Express could buy future pounds for US$1.5800 per pound in contracts worth £62,500 per contract. Multiple contracts could be bought, so that with 80 contracts the company could obtain the needed £5 million. However, since the exchange rate is worse than the forward rate (that is, it costs more dollars to buy the pounds), American Express will not consider a futures hedge.

Each of these financial hedges can protect American Express against foreign exchange risk. The company will want to choose the least costly hedge in this case, namely the forward market hedge. In other situations, one or another of these three alternatives will be the most beneficial to the firm. Beyond these choices, American Express should consider the possibility of structuring its business such that it could use British pound assets (for example, accounts receivable, investments, etc.) to hedge liabilities such as this purchase of equipment.

Developing forecasting and reporting systems

The management of foreign exchange risk can be both complex and cumbersome. A multinational with 20 subsidiaries can present a formidable challenge to the parent company because so many foreign exchange risk

decisions need to be made and monitored. However, there are a number of steps that MNEs typically take in creating the necessary system for managing these decisions. They may:

1 Decide the types and degrees of economic exposure that the company is willing to accept.

2 Develop the necessary expertise (in-house personnel and/or outside economists or consultants) for monitoring exchange rates and for forecasting those rates that are applicable to the identified exposures.

3 Construct a reporting system that allows the firm to identify exposed accounts, to measure this exposure, and to feed-back information on what the firm is doing and the status of these decisions.

4 Include all MNE units in this reporting system so that each better understands the risks it is assuming and is aware of the actions that must be taken to deal with these risks.

5 Keep senior-level management fully apprised of what is going on in each area of responsibility so that every regional or divisional manager is able periodically to revise the exposure risk and to make those strategy changes that will help more effectively to manage the process.

As firms begin to implement these five steps, they are better able to deal with the management of foreign exchange risk.

Active learning check

Review your answer to Active Learning Case question 3 and make any changes you like. Then compare your answer to the one below.

3 **If Siemens believes that the euro is going to appreciate in relation to the US dollar, how is it likely to deal with receivables and payables?**

If Siemens believes that the euro is going to get stronger against the US dollar, and if it is owed US dollars, the firm will try to collect them immediately before their value declines. At the same time Siemens will delay payment of those obligations that are fixed in US dollars because it will get more US dollars per euro after the appreciation, thus making it easier to pay those bills. The firm will lead collections and lag payables.

CAPITAL BUDGETING IN THE MNE

Capital project evaluation follows many of the same principles in an international firm as in a domestic firm, though additional variables and risks must be considered. Specifically, foreign projects must be evaluated for exchange risk, country risk, different financing costs and any problems associated with the transfer of products, services or funds due to government controls in any of the relevant countries. To see how these factors appear in the analysis, consider the following example of a food processing plant to be constructed by a US-based company in Qamaria (a fictitious country).

The company has developed the following pro forma income statement for the proposed investment project:

Proposed Qamaria processing plant pro forma income statement, typical year (in local currency)

Sales	10,000,000
Cost of goods sold:	
Local materials	1,000,000
Imported materials	2,000,000
Labour	3,000,000
Overhead expenses	600,000
Interest on loan from parent firm	400,000
Net income before tax	3,000,000
Local tax: 50%	1,500,000
Net income after tax	1,500,000

Assuming the investment made by the parent firm is 4 million in local currency, the project appears to have a simple return on capital of about 38 per cent per year (1,500,000/4,000,000). As long as the firm's cost of capital is less than 38 per cent, the project is worth undertaking.[1] The normal, domestic concerns apply to this project evaluation: that is, the estimate is only

as good as the forecasts of costs and sales. In addition, this foreign project faces potentially important considerations such as exchange risk, currency inconvertibility and other country risks, and preferential local borrowing opportunities. Chapter 14 provides more detailed discussion of this problem of country risk evaluation and management.

Exchange risk will affect the US dollar value of the profits earned, potentially raising or lowering them substantially. For example, if the local-currency value rises by 10 per cent in relation to the dollar, net income after tax will rise (in dollar terms) by 10 per cent, other things equal. However, if imported materials come from the United States, that cost (in local currency) will fall. Similarly, if the loan is made in dollars, interest cost (in local-currency terms) will fall. Sales, if any are exported from Qamaria, may decrease due to the exchange rate change.[2] In sum, a rise in the value of the local currency relative to the US dollar will tend to cause an increase in dollar profits from the affiliate, and such profits will tend to fall if the local currency devalues relative to the dollar.

Country risk (defined in Chapter 14) is another concern in the attempt to evaluate this project properly. If the host government decides to restrict profit remittances, then, no matter how profitable the project, the MNE will not be able to utilise its earnings elsewhere in the firm or to distribute them to shareholders. This problem is known as **currency inconvertibility**, regardless of whether the cause is a political decision or simply an economic reality. If discontent with the Qamaria government leads to strikes or violent confrontation between the government and opposition groups, the plant may be damaged or its production curtailed. Not all country risk is negative; if the government chooses to reduce corporate taxes to stimulate greater investment, the project may generate greater profitability than that shown above. In sum, country risks need to be considered when the full set of the project's financial implications is being judged.

Borrowing costs may differ in Qamaria and the United States. Thus, if the firm uses its **weighted-average cost of capital** in capital budgeting decisions, this project should be adjusted to account for any locally subsidised borrowing opportunity that exists. Many countries (and states or provinces within countries) offer low-interest loans to corporate investors to attract production facilities and jobs. If this is true in Qamaria and if the firm chooses to borrow some funds locally, the subsidised capital cost should be reflected in the capital budget. The project as shown uses an intracompany loan whose interest may be charged at the parent's actual cost of funds or marked up (or down) to achieve greater (or lesser) transfer of funds to the parent.

Finally, recall that the capital budget measures the project's *incremental impact* on the whole firm. Thus, if there are export sales from the parent to this new affiliate, those new sales must be counted in the evaluation. If the project replaces sales that were formerly exported to Qamaria, those lost sales must be counted. Any other intracompany impacts should also be measured in the project evaluation. This means the project should be judged in comparison to other alternatives available to the firm serving the Qamaria market. If exports from the United States offer a greater incremental profitability than the proposed plant, exports should be chosen. In summary, the incremental gains to the firm from the proposed project should be compared to the potential gains from other international business alternatives that may be available.

In contrast to domestic projects, one additional key question must be answered: who should conduct the analysis, the parent or the foreign subsidiary? Typically, the initial analysis is done at the subsidiary or branch level and then passed up to the head office for modification and/or approval. For example, two subsidiaries may both want to build a new tire plant and sell to the same market. Without coordination, they would compete against each other and the expected profits would not materialise. So the parent

corporation will make a decision that benefits the entire organisation. In this latter role the parent may have to turn down a positive NPV project from one subsidiary in favour of a higher NPV project from another subsidiary. The same process applies in reverse to plant closures: the shutdown will be at the plant with the largest negative NPV. Similarly, factories or holdings that do not generate sufficient profit may be sold.

Use of NPV

The parent company will review expenditure proposals because it has the necessary overall information to make these decisions. Moreover, such expenditure decisions will often be different from those of the subsidiary because the latter may use faulty valuation techniques or fail to address adequately the impact of political risk. In explaining why these differences occur, we must first review the basic NPV criterion. This criterion separates the financing and operating parts of the problem by discounting operating cash flows by a weighted-average cost of capital that embodies the financing decision. The NPV equation is:

$$\mathrm{NPV} = \sum_{t=0}^{T} \frac{I_t + C_t}{(1 + K_{\mathrm{A}})} \qquad (15.1)$$

where:

$$K_{\mathrm{A}} = k_{\mathrm{e}}\frac{S}{V} + k_{\mathrm{d}}(1 - t_x)\frac{D}{V} \qquad (15.2)$$

The definitions of the terms are:

I_t	= investment cash outlays in year t
C_t	= cash inflows in year t
T	= terminal date or end of project
K_A	= weighted–average cost of capital
k_e	= cost of equity capital
	= cost of debt financing

k_d	
t_x	= tax rate
D/V, S/V	= debt and equity ratios, respectively
NPV	= incremental net present value for the project.

In examining what determines the NPV, we must realise that disagreement between parent and subsidiary can arise because of the discount rate K_A, investment cost and annual cash flows. Political risk can also affect all values. For example, the risk of foreign currency controls can cause some of the future cash flows to be largely ignored by the parent. From the parent's perspective, if funds can no longer be remitted, their value is substantially reduced, since they are not available for dividend payments or for reinvestment elsewhere. Conversely, once foreign exchange controls are in place, the parent will often treat blocked funds as being less valuable. From the parent's perspective, the cost of future investments in the country, financed by these blocked funds, is reduced. In both cases the subsidiary is not directly concerned with the problem of foreign exchange controls, and it will discount all cash flows that are incremental from its own perspective.

Similarly, country risk may cause the parent to increase the discount rate or required return to reflect that risk. However, if the subsidiary does not agree with that perception, it will not increase the discount rate, so its calculation of the present value of the cash inflows and NPV will be higher. Moreover, if foreign exchange controls are enforced, the local capital markets can be isolated from the international capital market. From the subsidiary's perspective, the result may be lower local real interest rates, which make local investment opportunities seem attractive. However, the parent, looking at global opportunities, may decide that it will make more sense to draw capital out of the country for reinvestment elsewhere.

Another reason that parent and local NPVs may differ is faulty application of the NPV framework. The most common errors are in incorrectly choosing

t_x and K_A. The tax rate t_x is relevant in two places: the incremental tax that results from the incremental profits and the incremental tax shield that results from debt financing. Here, the errors usually come from a failure to determine the incremental tax rate. From the subsidiary's perspective the tax rate is the extra tax that it pays locally. However, the parent must also consider any incremental tax that it will pay once dividends are remitted.

In determining the discount rate K_A, several problems emerge. First, it is common that discount rates differ by several percentage points. The reason is obvious: inflation differs across different countries, and thus the inflationary premium built into the discount rate will differ. What the firm can never do is to use a discount rate from one country to evaluate cash flows denominated in another currency. The correct procedure is to calculate the real discount rate and then to 'gross it up' for the inflationary expectations of the relevant country.

Additionally, debt ratios differ across subsidiaries, and the weights in Equation 15.2 may alter the cost of capital. This will inevitably occur if the multinational maximises the use of debt financing in a country with subsidised borrowing rates. However, the debt ratio of that country is then not appropriate for determining the cost of capital, since the excess debt can be carried only because that subsidiary is part of a multinational. Similarly, it is a mistake to use the local real cost of debt to determine the cost of capital. In both these examples, if the MNE uses local debt norms and local debt costs, it is negating the advantage of being a multinational. That advantage is the ability to raise debt internally where it is the cheapest. As a result, in a country with a high debt cost the firm may have very little debt, whereas in a country with subsidised interest costs it may have a large amount of debt. In both cases there is no effect on the overall cost of funds to the multinational. Hence local debt norms and interest costs will be ignored unless local regulations restrict the use of debt funds to projects within that country. In this

instance, if the firm accepts a local project, it can also raise more subsidised foreign debt. If the money cannot be removed from the country by transfer pricing or whatever, then its cost is relevant in Equation 15.2.

Institutional features

Thus far the focus has been on the technical question of how to evaluate capital expenditures. However, a very important institutional factor that warrants attention is the impact of government policies such as subsidies and controls.

Government intervention can affect the profitability of a project or its financing. For example, in considering foreign investments, countries such as Australia and Canada have **foreign investment review agencies**, which review these investments to ensure that they benefit the local economy. As a result, foreign investment is often contingent on factors such as local employment quotas, local sourcing of components, the transfer of technology and a degree of local ownership. This intervention can obviously complicate capital expenditure analysis. Frequently the result is to forecast specific, quantitative outcomes. For example, if technology is locally licensed, what is the possible impact of its being leaked to different countries? If the MNE has to train local middle management and to sell shares locally, how does this affect the probability of forcible divestiture at some future date? In many cases the result of local content regulations is to expropriate all the advantages possessed by the multinational. One of the particular problems here is local ownership requirements. The parent's viewpoint is dominant on the assumption that the objective of the firm is to maximise its market value, which is owned by shareholders in the home country. However, once joint ventures and significant minority shareholdings are traded locally, this solution breaks down. The problem now becomes whose market value should be maximised? The result is that while minority ownership reduces the

political risk of expropriation, it restricts the multinational's freedom of action. It is, therefore, not surprising that, where political risk is lowered, minority shareholders get bought out.

INTERNATIONAL FINANCING IN THE MNE

The home office of an MNE should have available to it funding from the domestic money and capital markets, as well as from international money and capital markets. The funding sources available to a *foreign affiliate* of an MNE include debt and equity from the parent and local financing in the host country. Table 15.7 presents a view of these sources that expands on the view presented in Figure 15.1 and on the discussion in Chapter 7. The sources of credit to the MNE are divided between short- and long-term loans and between direct and intermediated provision of funds through a bank or some other financial institution.

Notice that in addition to the funding that was discussed earlier in the intrafirm context, numerous sources of external funding are available to the MNE. These sources include funding from domestic money and capital markets in each country where the firm operates, as well as funding from the euromarkets in money centres such as London, New York and Tokyo. A large firm from Norway, for example, could seek financing in the US market through international bank loans, through bond issue or even through issuing stock shares or American Depositary Receipts.[3]

Table 15.7 International sources of credit (including markets and intrafirm transfers)

Borrowing	Domestic inside the firm	Domestic market	Foreign inside the firm	Foreign market	Euromarket
Direct, short term	Intrafirm loans, transfer pricing, royalties, fees, service charges	Commercial paper, other promissory notes, commercial credit	International intrafirm loans, international transfer pricing, dividends, royalties, fees	Commercial credit	Eurocommercial paper
Intermediated, short term	Short-term bank loans, discounted receivables	International back-to-back loans	Short-term bank loans, discounted receivables	Euro short-term loans	
Direct, long term	Intrafirm loans, investment in affiliates	Stock issue, bond issue	International intrafirm long-term loans, FDI	Stock issue, bond issue, ADR issue	Eurobonds, euroequity
Intermediated, long term		Long-term bank loans	International back-to-back loans	Long-term bank loans	Euro long-term loans

Note: *Direct* means borrowing from owners of wealth (e.g., investors); *intermediated* means borrowing from a financial intermediary (e.g., a bank). International back-to-back loan means a loan in which two companies in different countries borrow offsetting amounts from one another in each other's currency.

Financial structure

Financial structure in an MNE is complicated by the fact that the 'normal' **debt–equity ratio** differs from industry to industry and from country to country. For example, the average debt–equity ratio in large Japanese companies is much higher than in US firms and historically has been four times higher. In the United States, this ratio is generally far less than 1, averaging about 0.6 for non-financial industries as a whole. As a rule, the total financial structure of an MNE follows the standards of the home-country financial market, since shares are usually traded there. On the other hand, a US company's affiliate in Japan may be able to operate successfully with far higher leverage than that of the parent, given local conditions in Japan. Thus, the financial structures of foreign affiliates may differ from that of the overall firm or that of the parent in particular. The only limitation is that the financial structure of the affiliate must not cause the financial structure of the entire firm to deviate from acceptable standards in the home country.

The entire MNE may choose to meet its external financing needs by borrowing through an affiliate in a low-interest country if such funding is available and if exchange rate protection still leaves financing costs lower than those in other currencies. As already noted, since the MNE is evaluated by investors in the home country, its overall debt–equity structure must satisfy the financial community in that country. However, if the firm sells shares of an affiliate in the host country's financial market, the debt–equity position of the affiliate is an important issue.

For a wholly owned foreign subsidiary that does not sell shares in the host country, the debt–equity ratio should be determined by overall corporate needs. If funding is available at low cost (adjusted for expected exchange rate changes), local borrowing is appropriate. If a substantial amount of assets is exposed locally, local borrowing provides a hedge to both exchange and country risks. If the local currency is expected to devalue substantially, then, even if local interest rates are high, it may make sense to borrow locally, assuming the expected post-devaluation interest costs would be lower than the home-country costs.

Local equity financing may be forced on the firm if the host government demands partial local ownership of foreign enterprises. This situation exists today in many less developed countries and in most of the formerly communist countries. In this case, the affiliate's debt–equity ratio may be skewed towards equity, especially if the parent seeks to avoid sending funds into that country. That is, financing for the affiliate would come from the local partner's equity investment plus retained earnings, and other funding would be sought only after these sources were used up.

In countries with restrictions on funds transfers, such as profit and royalty remittances, equity financing would again be sensible – using those funds that cannot be taken out of the country. That is, if funds are blocked from transfer abroad, the MNE must reinvest them locally; investing the funds in the

existing operation (that is, profit reinvestment) may offer a greater benefit than placing them in local financial instruments such as bank deposits or government securities. This strategy is widely used by multinationals, though most would prefer the freedom to take their funds out of the host country.

Finally, notice that *if* the MNE is able to lower its total borrowing costs by utilising foreign sources of funds, it has gained an advantage relative to domestic firms that limit themselves to domestic financial markets in any country. If the MNE has a lower weighted-average cost of capital for any given capital budget, it will undertake more projects than the purely domestic firm (or will be more profitable in the same projects).

Active learning check

Review your answer to Active Learning Case question 4 and make any changes you like. Then compare your answer to the one below.

4 When Siemens is looking to invest in its foreign affiliates around the world, what are some of the important considerations in choosing among alternative financing sources?

When Siemens is looking to invest in its foreign affiliates around the world, two important considerations are the size of the investment and the timescale involved. For large investments it will normally go to domestic or foreign funding markets for loans, rather than rely on internal financing mechanisms. As listed in Table 15.7 there are a variety of options. To reduce risk it can spread its borrowing across a portfolio of loans and institutions. By using eurocurrency markets in London or mainland Europe, it can minimise its short-term borrowing costs, and it can also issue commercial paper in New York or London to obtain working capital. For longer-term borrowing, Siemens could issue shares in the United States or in another money centre such as Frankfurt or Tokyo, as well as issuing bonds in a low-tax jurisdiction such as Luxembourg. The choices depend on interest rates, exchange rates and currencies in which Siemens will have cash flows in the future.

CONTROL: IDENTIFYING OBJECTIVES, EVALUATING AFFILIATE PERFORMANCE AND MAKING PERFORMANCE CONSISTENT WITH GOALS

Control is the fundamental function of management that involves developing profit plans for the firm and its divisions and then deciding what to do when actual operating results differ from those planned. For a foreign investment project, the financial control process generally begins with putting together a set of pro forma financial statements (income statement, balance sheet, cash flow report). Then detailed budgets are developed for individual divisions, allocating the full capital budget to the specific purposes for which it will be used. During the time period after the creation of these plans, the firm's management observes the results and notes any deviations from the budget. Usually, of course, actual results differ from budgeted ones. Finally, the firm develops and implements a management plan for dealing with the deviations. The process is cyclical – as each planning period ends, another begins – and new budgets and managerial contingencies may be developed.

In the multinational firm, the potential for substantial home-office control over affiliates exists because major capital budgeting usually requires more resources than those available in an affiliate, and home-office assistance is needed to carry out capital projects. In addition, financial reporting to the parent company provides an informational basis for controls, which may or may not be exercised, depending on the extent of the firm's decentralisation. Finally, because the people assigned to manage foreign affiliates are usually well known to the home-office managers, an informal, personal contact ties

affiliates to the home office. All of this means that the home office has the potential to impose heavy controls on the activities of foreign affiliates.

The process described so far is substantially equivalent to the one used to evaluate and control domestic divisions in a firm. But foreign affiliates face a wide range of additional factors that may affect their performance, and these factors should be considered when setting the goals and judging the performance of affiliates. How should the managers of foreign affiliates be evaluated for their financial performance? If they are evaluated in local-currency terms, the home office must worry about hedging foreign currency exposures and about remitting or reinvesting profits. If they are evaluated in home-currency terms, affiliate managers must deal with exchange risk and remittance policy. If they are limited in their financial dealings due to centralised cash and foreign exchange management policies but are evaluated in home-currency terms, it must be recognised that their options are limited. On another issue, if transfer prices are set to move funds to the home office, foreign profitability will look lower than it would if these prices were set to keep more funds in the affiliates. Correct evaluation of the performance of affiliate managers must take into account the constraints imposed on the affiliates.

STRATEGIC INTERNATIONAL FINANCE

There are a number of ways in which MNEs apply the international financial concepts that have been discussed in this chapter. Whether expanding or consolidating global operations, financial management analysis can be used by MNE managers to determine which activities and which locations to invest in or exit from.

Establishing overseas operations

Because the United States is a major market for many international firms, foreign MNEs have been particularly concerned about the value of the US dollar. For example, when Ford Motor acquired Volvo's automotive business, the Swedish firm insisted on receiving the purchase price in krona. This concern has also resulted in foreign firms setting up operations in the United States in order to offset the competitive impact associated with having a currency that is very strong vis-à-vis the US dollar. For example, BMW built an auto production facility in South Carolina because it found it was 20 per cent less costly to produce cars in South Carolina than to bring them in from Germany.[4] Other companies have made acquisitions in the US market in order to protect their overall profitability. At the same time, MNEs continue to invest in China, although not at the level of the early-2000s. By expanding the number of overseas operations the MNE reduces its currency risk by diversifying the company's cash flows into additional currencies.

Reducing financial risk

Although some of the above strategies are useful in reducing risk, there are other tactics that are also particularly useful, including mergers, acquisitions,

joint ventures for new, high-risk projects, partnering with established MNEs in order to gain international market share and cutting operating costs through new plant design.

KEY POINTS

1 International financial management encompasses a number of critical areas, including the management of global cash flows, foreign exchange risk management, capital expenditure analysis and international financing. In carrying out these financial activities, MNEs can use three approaches or solutions: polycentric, ethnocentric or geocentric.

2 There are three main areas of consideration in managing global cash flows. One is the movement of cash so that each subsidiary has the working capital needed to conduct operations. A second area is the use of funds positioning techniques that can help to reduce taxes and to deal with political and legal roadblocks that impede cash flows. A third is multilateral netting, which ensures that transactions between the subsidiaries are paid in a timely manner.

3 Foreign exchange risk management encompasses a variety of financial strategies that are designed to limit the multinational's exposure to exchange rate fluctuations. In particular, the MNE will want to reduce translation, transaction and economic exposure. One of the most common ways of doing this is through hedging. Examples include the purchase of forward exchange contracts and the balancing of foreign currency assets with foreign currency liabilities.

4 A third major strategic financial issue is capital expenditure analysis. This entails computation and deliberation of such matters as the weighted cost of capital and the degree of political risk that is being assumed. Some of the methods of dealing with these issues were discussed, with attention given to the fact that the final decision on

capital expenditures is often affected by subjective considerations as well as by objective evaluations.

5 Whether expanding or consolidating global operations, financial management analysis can be used by MNE managers to determine which activities and which locations to invest in or exit from.

Key terms

- **polycentric solution**
- **ethnocentric solution**
- **working capital**
- **geocentric solution**
- **multilateral netting**
- **funds positioning techniques**
- **transfer price**
- **arm's-length price**
- **tax havens**
- **fronting loan**
- **clearing account**
- **hedge**
- **transaction risk**
- **translation risk**
- **consolidation**
- **balance sheet hedging**

- **economic risk**
- **currency option**
- **currency inconvertibility**
- **weighted-average cost of capital (WACC)**
- **foreign investment review agency**
- **debt–equity ratio**
- **control**

REVIEW AND DISCUSSION QUESTIONS

1 In determining parent–subsidiary relationships, how does a polycentric solution differ from an ethnocentric or geocentric solution? Compare and contrast all three.

2 What is meant by the term *working capital*, and what are two of the most common ways in which parent companies can provide this capital to their subsidiaries? What are two ways in which the parent can obtain funds from the subsidiaries?

3 How can an MNE shift profits through the use of transfer pricing? Provide an example.

4 Of what value is multilateral netting in helping MNEs to manage cash flows? Give an example.

5 If a foreign country is facing high inflation, what are three financial strategies that the local multinational unit might employ? Identify and describe each.

6 Why are MNEs interested in translation and consolidation of financial statements? Of what practical value is this activity to the company?

7 Under what conditions will an MNE face translation exposure? What financial strategy might the organisation use to minimise this exposure?

8 When might an MNE face transaction exposure? What is a financial strategy that the firm could use to minimise this risk?

9 What is meant by the term *economic exposure*? What is a financial strategy that an MNE could use to minimise this risk?

10 When would a multinational use a lead strategy to hedge a risk? When would a multinational use a lag strategy for this purpose? In each case, give an example. A lead strategy is a choice by an MNE to make intracompany payments (for example, from an affiliate to the home office) earlier than in an arm’s-length situation, to move funds out of the country of the affiliate more rapidly. A lag strategy is a choice by an MNE to make intracompany payments (for example, from an affiliate to the home office) later than in an arm’s-length situation, to hold funds longer in the affiliate country.

11 When might an MNE use a forward exchange contract (a contract with a bank to buy or sell foreign exchange at a future date, with the exchange rate and value fixed today)? When might the firm decide to forgo this strategy and leave a particular foreign currency transaction unhedged?

12 What role does net present value (NPV) play in the review of capital expenditure proposals? Give an example.

13 How can country risk affect the computation of NPV? Will the risk result in the MNE wanting a higher or a lower NPV? Explain.

14 Why do parent and local subsidiaries sometimes differ in their calculation of NPV for a particular project or expenditure? How can this difference be resolved?

15 What are some of the financing alternatives available to MNEs that are not available to domestic firms? Give an example.

REAL CASE

Carillion's collapse

With a history stretching back over one hundred years, Carillion grew to employ 43,000 individuals globally by 2018, 19,000 of whom were based in the UK. The firm was performing well, with consistent growth in revenues in recent years. The 2016–17 financial year was, in fact, exceptional, with Carillion reporting $6.76 billion in revenue; 14 per cent higher than the preceding year. The fate of this construction giant, however, took a drastic turn in 2017 which ultimately resulted in the closure of the business in 2018, marking a historical year for the UK construction industry.

Carillion's operating activities could be broken down into three main segments namely: support services; project funding; and construction services. Support services encompassed maintenance, facilities management and energy services for major buildings and large property estates. This division of the business also included infrastructure services for roads, railways and utility networks, telecommunications, power transmission, distribution and remote site accommodation services. The company arranged finance for Public Private Partnership Projects to deliver public sector buildings and infrastructure. Finally, construction services heavily focused on large-scale buildings and infrastructure contracts for long-term public and private sector clients. Carillion's project portfolio was diverse, leading to some labelling the firm as a 'Jack of all trades'. As of 2016, 52 per cent and 42 per cent of Carillion's revenue were generated from support services and construction services respectively. Although only 6 per cent of revenues were acquired with Public Private Partnership Projects in 2016, the firm was heavily dependent on the success of projects within the UK, as this market accounted for 74 per cent of revenue (Table 15.8).

Information technology has transformed the financial services and insurance business into a universal product. Instead of large numbers of white-collar clerical workers toiling in large local banking and insurance halls (like Bob Cratchit in Dickens's *A Christmas Carol*), today such services can be provided on the internet by smaller, more entrepreneurial groups and even from a home office. This is part of the global knowledge-based economy.

Table 15.8 Carillion's global revenue 2014–16

Year	UK	Canada	Middle East & North Africa	Total
2016	74%	11%	15%	$6.76 billion
2015	73%	11%	16%	$5.98 billion
2014	73%	14%	13%	$5.33 billion

Source: Carillion (2016).

In July 2017, Carillion issued a profit warning. This triggered a fall in its share price, which subsequently dropped 90 per cent before the firm collapsed. An important trigger for Carillion was a series of cost overruns across a number of projects. Despite being one of the most profitable firms in the UK, Carillion was hit by a combination of cost overruns and delayed payments, particularly in relation to its three main UK contracts that had a combined worth of approximately $1.82 billion.

Although its operations in the UK were a key contributory factor in its collapse, it is important to note that Carillion's investment overseas was also a serious cause for concern. With the inclusion of employees in joint ventures, approximately 19,000 people worked for Carillion in the Gulf. Payments for several major projects in the Middle East in particular were delayed leading to a major problem with cash flow. This is exemplified by Carillion's largest contract in the Middle East: a $650-million deal for development work in downtown Doha, Qatar's capital, in preparation for the World Cup. This joint venture contract was secured by Carillion in 2011 and was backed by the Qatar Foundation. However, Carillion executives were involved in a dispute with the foundation over $260 million, over what is believed to be unpaid trade receivables. In July 2017, when the company announced an $1,098 million deficit in its finances, it has been reported that approximately $408 million of this deficit was attributed to projects in the Middle East and the Gulf. However, the developers in the Middle East argued that they were the ones owed money, citing Carillion's failure to fulfil contractual obligations. Carillion's activities in the Middle East shrunk substantially in 2017 and the firm announced its exit from Saudi Arabia, Qatar and Egypt in July 2017. Carillion also sold its 50 per cent stake in Carillion Alawi, a joint venture with Oman's Zawawi family in 2017.

Over-dependency on the UK market had been a major reason for Carillion to pursue an internationalisation strategy over the 15 years before its demise. It pursued an aggressive global

strategy of merges and acquisitions, spending over $1.7 billion in diversifying its project portfolio. More information concerning each of the acquisitions is highlighted below.

Timeline of Carillion's recent acquisitions

- **2001** – Expanded into the facilities management services sector and acquired the remaining 51 per cent of GT Rail Maintenance, thus, forming Carillion Rail.
- **2002** – Acquired Citex Management Services for $15 million.
- **2005** – Purchased Planned Maintenance Group for $52 million.
- **2006** – Acquired Mowlem (support services firm) for $455 million.
- **2008** – Purchased Alfred McAlpine for $743 million and increased its global presence by acquiring Vanbots Construction in Canada for $18.6 million.
- **2011** – Acquired Eaga (Energy Efficiency Company) for $398 million.
- **2012** – Acquired a 49 per cent stake in The Bouchier Group for $31 million, who provided services in the Athabasca oil sands area.
- **2013** – Purchased the facilities management division of John Laing.
- **2014** – Carillion increased its Canadian presence by acquiring a 60 per cent stake in Rokstad Power Corporation for $43 million, a transmission and distribution company. Previously in 2014, Carillion made three offers concerning a merger with long rival construction company Balfour Beatty, all of which were rejected. Furthermore, Balfour Beatty ensured that Carillion were not allowed to make a fourth offer by refusing more time for negotiations.
- **2015** – Purchased the Outland Group in Canada, who provided goods to camps at remote locations in Canada.
- **2016** – Purchased a majority stake in Ask Real Estate

Diversifying product offerings can also be a useful strategy to spread business risk, but it also increases operational and strategic complexity. Diversifying can create economies of scale and cross-

business synergies; however, the synergistic benefits to Carillion of providing such a wide array of good and services is questionable. As of 2017, the firm owned 326 subsidiaries around the world overseen by 169 Directors. This complexity in management resulted senior management finding it extremely difficult to track the overall risk exposure of the firm. Some argue that the firm had grown too large, too quickly.

In conclusion, racing to secure bids over rival construction companies, Carillion, the second-largest construction firm in the UK, hit a financial tipping point, lost the backing of the banks and collapsed. Its aggressive growth strategy and the diversification of its business portfolio increased the complexity of its internal structure. Coupled with poor oversight of its global day-to-day operations, over-runs on flagship projects and an unclear corporate governance structure, the firm accumulated debts of approximately $1.95 billion. While for some, the demise of the construction giant may have been unexpected, for others, Carillion's collapse was perhaps an inevitable outcome.

Sources: Collinson, S.C. and Jay, M. (2012) *From Complexity to Simplicity*, Macmillan, Basingstoke. https://www.constructionnews.co.uk/companies/clients/crossrail/crossrail-which-contracts-had-the-biggest-cost-overruns/10022332.article; https://www.ft.com/content/27703788-00ff-11e8-9650-9c0ad2d7c5b5 https://www.thetimes.co.uk/article/qatar-owed-carillion-200m-for-world-cup-building-work-z9jjkd3gt https://www.ft.com/content/0e29ec10-f925-11e7-9b32-d7d59aace167; http://www.bbc.co.uk/news/business-42717735; http://www.telegraph.co.uk/business/2018/01/15/carillion-could-owe-supply-chain-1bn-30000-businesses-face-financial/; http://www.telegraph.co.uk/business/2018/01/15/carillion-could-owe-supply-chain-1bn-30000-businesses-face-financial/; https://www.thenational.ae/business/property/business-as-usual-in-uae-despite-liquidation-of-uk-construction-firm-carillion-1.695675; http://www.bbc.co.uk/news/business-42870816; https://www.expressandstar.com/news/business/2018/02/08/carillion-2000-jobs-saved-but-the-number-lost-has-now-risen-to-900/; https://www.theguardian.com/business/2018/feb/14/carillion-a-month-after-its-collapse-employees-partners-and-rivals-are-still-feeling-the-pain.

1 What role did Carillion's diversification strategy play in the demise of the company?

2 How dependent was Carillion on the UK market?

3 Discuss whether Carillion's financial difficulties was largely attributable from operations in the Middle East.

REAL CASE

M-Pesa: Kenya's mobile money service leapfrogging traditional banks

Over the past decade the global south has moved ahead of the curve in mobile banking. By 2010, 78 per cent or 697 million people using mobile banks were from Asia, Africa, the Middle East and Latin America. Since then, usage rates have grown faster and expanded further across all parts of the developing world.

In developed nations, the legacy technologies left by centuries of progress are visible at the street level, from the neglected telephone box, to fixed line telephone wiring. In developing nations, particularly those in Africa, the technological revolution has allowed them to 'leapfrog' out-dated technologies and side-step incumbent providers. Kenya is one of many African nations that have bypassed the era of landlines with 86 per cent of the population having a mobile phone subscription. Kenya also has the highest global share of internet usage accessed from mobile phones at 83 per cent, ahead of Nigeria 82 per cent and India 79 per cent.

Mobile phone usage is having significant impacts on Kenya's economy. The biggest being the ability to save, transfer and invest money remotely, via mobiles. According to *The Economist*, a 10 per cent increase in mobile-phone penetration in poor countries accelerates per-person GDP growth by 0.8–1.2 per cent a year.

M-Pesa is one of the biggest platforms, launched by Vodafone owned Safaricom, Kenya's largest mobile operator in March 2007. M-Pesa, 'pesa' meaning 'money' in Swahili, has revolutionised the way Kenyans participate in the economy by leapfrogging traditional banking transactions. As highlighted in Figure 15.5, M-Pesa has grown rapidly, with 18 million users in Kenya and 110,000 agents (out of 287,400 worldwide); 40 per cent more than the number of bank ATMs. The M-Pesa system began with SMS texting to electronically transfer and withdraw small funds of less-than US$675. Actual exchange of money is carried out through the network of agents which act as ATMs and are located in shops, gas stations and post offices. In 2012, M-Pesa expanded to allow interest-paying savings accounts and the ability to access small loans. From 2017, the platforms allowed

small farmers to link with suppliers and have since launched a mobile app as they continue to expand.

In 2017, on its 10th anniversary M-Pesa had reached 30 million users in 10 countries, outlined in Figure 15.6, with huge growth potential in the Middle East and North Africa. There have been wide spread impacts in Kenya, a study by MIT economists Suri and Jack (2016), found that mobile money systems helped lift 194,000 Kenyans or 2 per cent of the population from extreme poverty in eight years. M-Pesa has had direct impacts on Nairobi's start-up economy, $32.8 million was raised in 2017, the third largest amount from one country on the continent. Furthermore, their study highlights the importance of mobile money for individuals in improving financial resilience, the ability to send and receive remittances, and financial saving. This was found to be especially impactful in female-led households, leading to improved labour market outcomes. Kenyans, particularly women, had improved occupational choice moving from agriculture into business (Suri and Jack, 2016).

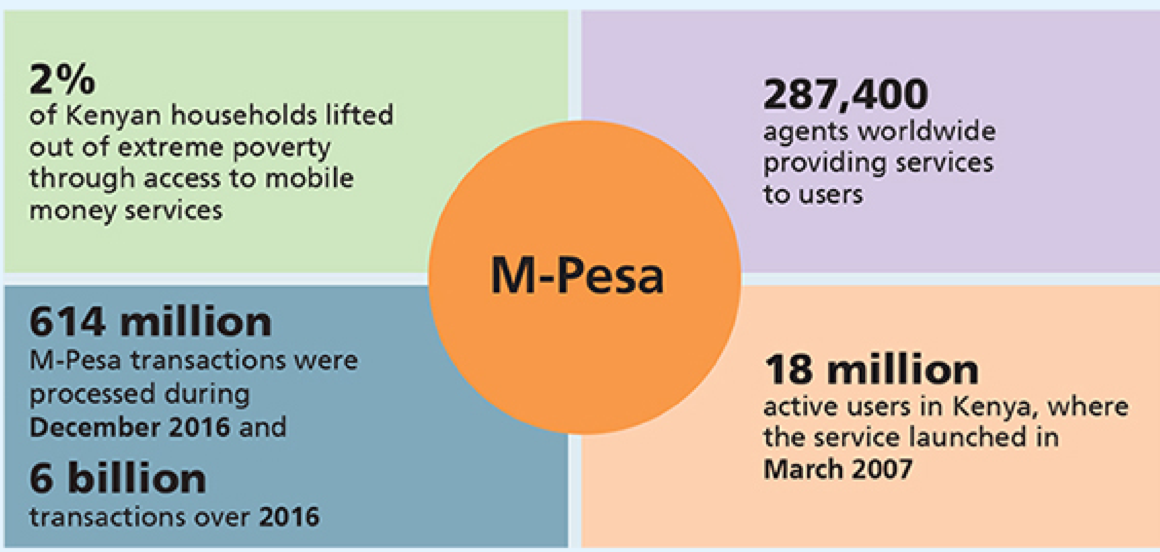

Figure 15.5 M-Pesa by the numbers

Source: https://www.cnn.com/2017/02/21/africa/mpesa-10th-anniversary/index.html.

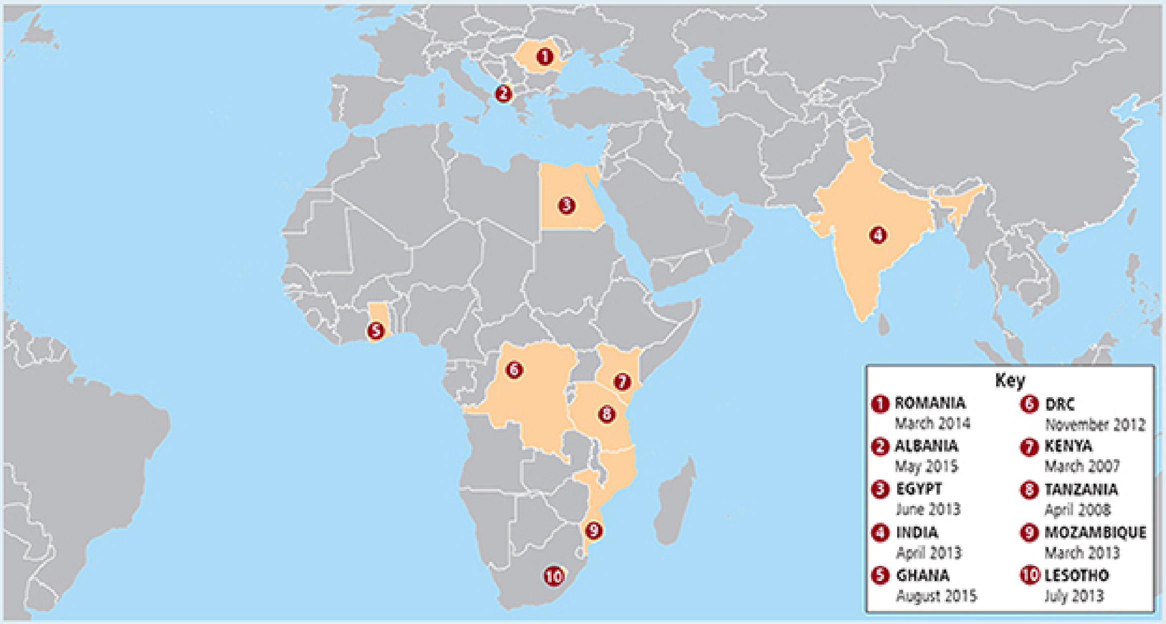

Figure 15.6 **M-Pesa around the world: launch dates**

Source: https://www.cnn.com/2017/02/21/africa/mpesa-10th-anniversary/index.html.

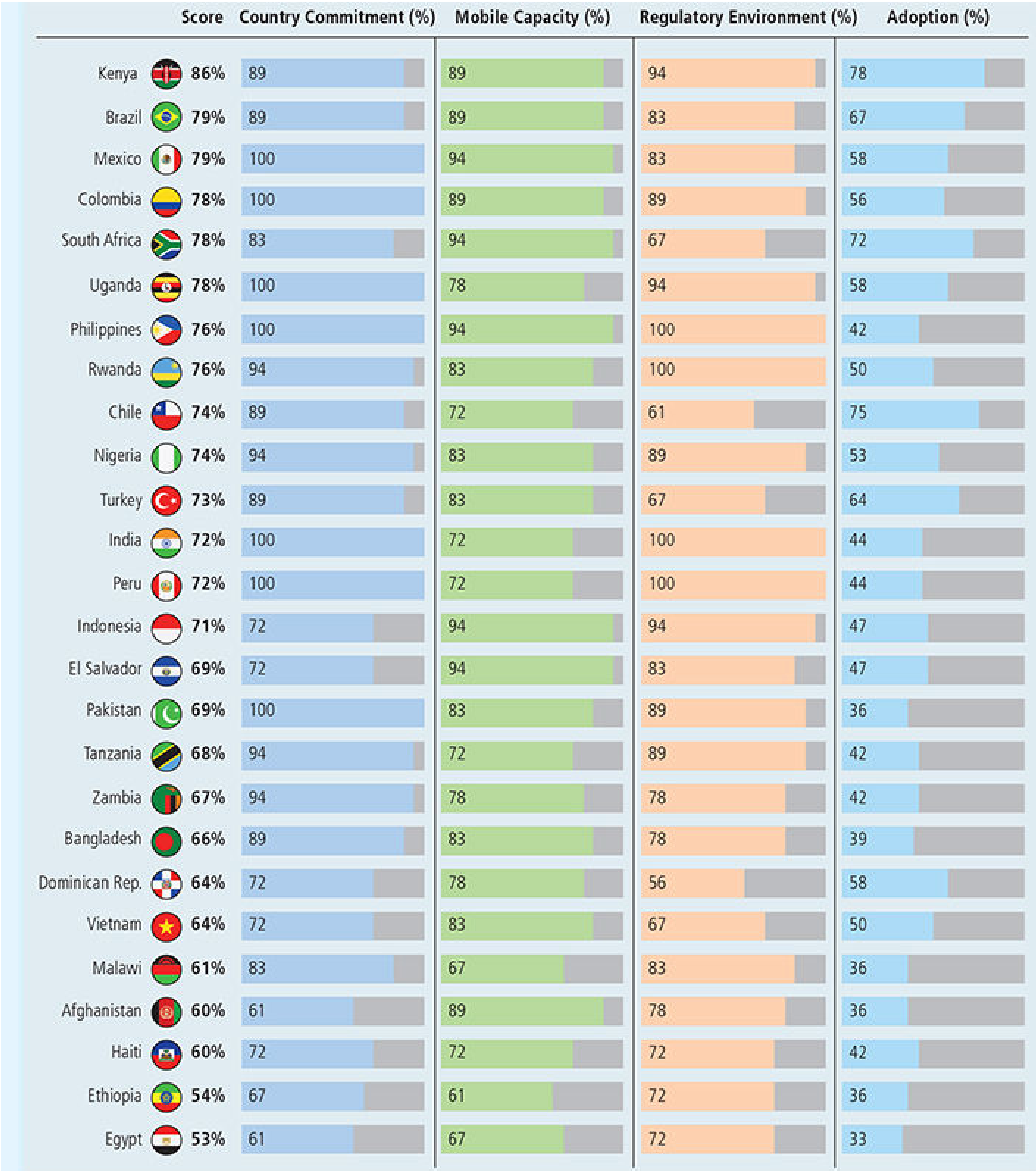

Figure 15.7 The 2017 Brookings Financial and Digital Inclusion Project key findings

Source: https://www.brookings.edu/wp-content/uploads/2017/08/fdip_20170831_project_report.pdf.

More broadly, when we compare across countries, mobile money was attributed as a key determining factor in Kenya ranking as number one for a third year in a row in Brookings 2017

Financial and Digital Inclusion Project Report. The report scores 26 developing countries on their commitment and progress towards financial inclusion. As shown in Figure 15.7, Kenya ranks highly in mobile capacity and regulatory environment, scoring higher than other African nations such as South Africa (78 per cent), Rwanda (76 per cent) and Nigeria (74 per cent). The widespread adoption of M-Pesa, driven by both new technologies and a new business model for transferring and lending money has enabled Kenyan's to leapfrog the traditional banking system and access new development opportunities.

Sources: The Economist (2017) https://www.economist.com/special-report/2017/11/10/beefing-up-mobile-phone-and-internet-penetration-in-africa; Brookings Infographic – https://www.brookings.edu/wp-content/uploads/2017/08/fdip_20170831_project_report.pdf; *Business Daily* (2018) https://www.businessdailyafrica.com/corporate/tech/Kenya-tops-in-phone-internet-traffic-/4258474-4349966-3m4lrez/index.html; WBG (2017) https://data.worldbank.org/indicator/IT.CEL.SETS.P2?end=2017&locations=KE&name_desc=false&start=2017
Suri, T. and Jack, W. 'The long-run poverty and gender impacts of mobile money', *Science*, vol. 354, no. 6317 (2016), pp. 1288–92; NYT (2010) https://www.nytimes.com/2010/11/29/business/global/29iht-mobilebanks29.html; CNN (2017) https://www.cnn.com/2017/02/21/africa/mpesa-10th-anniversary/index.html; WBG (2018) https://www.worldbank.org/en/news/feature/2018/10/03/what-kenya-s-mobile-money-success-could-mean-for-the-arab-world.

1 Why has the use of mobile banking grown so fast in developing countries, compared to developed countries?

2 How has the uptake of mobile banking services had an impact on the Kenyan economy? In what ways are people's lives changed by these services, particularly in terms of 'digital inclusion'?

3 How could the global spread of mobile banking services change the way international trade is conducted?

NOTES

1 A full set of the measures used in capital budgeting appears in basic finance texts, such as Richard A. Brealey and Stewart C. Myers, *Principles of Corporate Finance*, 9th ed. (Boston, MA: McGraw-Hill, 2010).

2 However, if the local-currency price goes up due to the currency revaluation and demand is price inelastic, the total revenue received may go up even if the quantity sold declines.

3 ADRs (American Depositary Receipts) are a derivative instrument based on shares of stock in a company. The issuing company typically sells a large quantity of shares in a block to an investment bank, which in turn holds those shares in its own treasury. The investment bank then issues ADRs whose value is based completely on the original shares, converted into US dollars, in the US market.

4 Also, see John Templeman and James B. Treece, 'BMW's comeback', *Business Week*, 14 February 1994, pp. 42–4; 'BMW to invest £500m in UK factories', *BBC News*, 9 June 2011.

BIBLIOGRAPHY

Bates, Thomas W., Kahle, Katheleen M. and Stulz, Rene M. 'Why do US firms hold so much more cash than they used to?' *Journal of Finance*, vol. 64, no. 5 (October 2009).

Bartram, Soehnke M., Brown, Gregory W. and Minton, Bernadette A. 'Resolving the exposure puzzle: the many facets of exchange rate exposure', *Journal of Financial Economics*, vol. 95, no. 2 (2010).

Chang, Shao-Chi and Wang, Chi-Feng. 'The effect of product diversification strategies on the relationship between international diversification and firm performance', *Journal of World Business*, vol. 42, no.1 (2007).

Dauth, Tobias, Pronobis, Paul and Schmid, Stefan. 'Exploring the link between internationalization of top management and accounting quality: The CFO's international experience matters', *International business review*, vol. 26, no. 1 (2017).

Di Gregorio, Dante. 'Re-thinking country risk: insights from entrepreneurship theory', *International Business Review*, vol. 14 (2005).

Dos Santos, Marcelo B., Errunza, Vihang R. and Miller, Darius P. 'Does corporate international diversification destroy value? Evidence from cross-border mergers and acquisitions', *Journal of Banking and Finance*, vol. 32, no. 12 (2008).

Eckert, Stefan, and Trautnitz, Georg. 'A commentary on risk reduction by geographic diversification', *Multinational Business Review*, vol. 18, no. 1 (2010).

Eden, Lorraine. 'Taxes, transfer pricing, and the multinational enterprise.' In Alan M. Rugman (ed.), *The Oxford Handbook of International Business* (Oxford: Oxford University Press, 2009).

Eden, Lorraine, Juarez Valdez, Luis F. and Li, Dan. 'Talk softly but carry a big stick: transfer pricing penalties and the market valuation of Japanese multinationals in the United States', *Journal of International Business Studies*, vol. 36, no. 4 (July 2005).

Gande, Amar, Schenzler, Christoph and Senbet, Lemma W. 'Valuation effects of global diversification', *Journal of International Business Studies*, vol. 40 (2009).

Grosse, Robert, *The Future of Global Financial Services* (Oxford: Blackwell, 2008).

Gubbi, Sathyajit R., Aulakh, Preet S., Sougata, R., Sarkar, M. B. and Chittoor, Raveendra. 'Do international acquisitions by emerging-economy firms create shareholder value? The case of Indian firms', *Journal of International Business Studies*, vol. 41 (2010).

Hermes, Niels, Smid, Peter and Lu, Yao. 'Capital budgeting practices: a comparative study of the Netherlands and China', *International Business Review*, vol. 16, no. 5 (October 2007).

Huang, Jing. 'Foreign earnings management of US multinational companies: The role of decision rights', *Journal of International Business Studies*, vol. 49, no. 5 (2018).

Jiang, Xu and Li, Yuan. 'The relationship between organizational learning and firms' financial performance in strategic alliances: a contingency approach', *Journal of World Business*, vol. 43, no. 3 (2008).

Johannesen, Niels and Zucman, Gabriel. 'The end of bank secrecy? An evaluation of the G20 tax haven crackdown', *American Economic Journal: Economic Policy*, vol. 6, no. 1 (2014).

Jones, Chris and Temouri, Yama. 'The determinants of tax haven FDI', *Journal of World Business*, vol. 51, no. 2 (2016).

Lee, Seung-Hyun and Makhija, Mona. 'The effect of domestic uncertainty on the real options value of international investments', *Journal of*

International Business Studies, vol. 40, no. 3 (2009).

Li, Lei, Li, Dan, Goerzen, Anthony and Shi, Weilei Stone. 'What and how do SMEs gain by going international? A longitudinal investigation of financial and intellectual resource growth', *Journal of World Business*, vol. 53, no. 6 (2018).

Lel, Ugur, Miller, Darius and Reisel, Natalia. 'Explaining top management turnover in private corporations: The role of cross-country legal institutions and capital market forces', *Journal of International Business Studies* (2016).

Liebowitz, Seth Jay, Gerde, Virginia W. and Davies, Antony. 'Employee-oriented management practices and the firm's financial performance: what causes what?', *Academy of Management Proceedings* (January 2015).

Massa, Massimo and Zhang, Lei. 'Does corporate hedging attract foreign institutional investors? Evidence from international firms', *Journal of International Business Studies*, vol. 49, no. 5 (2018).

Qi, Yaxuan, Roth, Lukas and Wald, John K. 'How legal environments affect the use of bond covenants', *Journal of International Business Studies*, vol. 42 (2011).

Qian, Gongming, Li, Lee and Rugman, Alan M. 'Liability of country foreignness and liability of regional foreignness: their effects on geographic diversification and firm performance', *Journal of International Business Studies*, vol. 44, no. 6 (2013).

Reuer, Jeffrey J., Shenkar, Oded and Ragozzino, Roberto. 'Mitigating risk in international mergers and acquisitions: the role of contingent payouts', *Journal of International Business Studies*, vol. 35, no. 1 (January 2004).

Rugman, Alan M. 'Twenty-five years of "international diversification and the multinational enterprise"', In Alain Verbeke (ed.), *Internalization,*

International Diversification and the Multinational Enterprise – Essays in Honor of Alan M. Rugman (London: Elsevier, 2005).

Rugman, Alan M. and Jing, Li. ‘Real options and the theory of foreign direct investment’, *International Business Review*, vol. 16, no. 6 (December 2007).

Rugman, Alan M. and Oh, Chang Hoon. ‘Regional multinational enterprises and the international financial crisis.’ In J. Berrill, E. Houston and R. Sinkovics (eds.), *Firm-level Internationalization, Regionalism and Globalization* (Basingstoke: Palgrave, 2011).

Song, Sangcheol, Lee, Seung-Hyun and Makhija, Mona. ‘Operational hedging in foreign direct investments under volatile and divergent exchange rates across countries’, *Journal of World Business*, vol. 50, no. 3 (2015).

Zattoni, Alessandro, Witt, Michael A., Judge, William Q., Talaulicar, Till, Chen, Jean Jinghan, Lewellyn, Krista, Hu, Helen Wei et al. ‘Does board independence influence financial performance in IPO firms? The moderating role of the national business system’, *Journal of World Business*, vol. 52, no. 5 (2017).

Part Five

REGIONAL STRATEGIES

Chapter 16

EUROPEAN UNION

Contents

Objectives of the chapter

The European Union (EU) is the largest of the world's triad markets. It is the home of about a quarter of the world's largest 500 firms. Many foreign MNEs from Asia and North America are now doing business in the EU or are targeting the area in their expansion plans. This chapter examines the EU environment and reviews some of the major strategy considerations that must be addressed by companies doing business in this economic bloc.

The specific objectives of this chapter are to:

1. *Describe* the Single European Market and the competitive status of the EU in relation to other triad members.
2. *Discuss* how firms carry out an overall strategic analysis of the EU market in terms of competitive intelligence and evaluation of location.
3. *Relate* some of the major strategy issues that must be considered when doing business in the EU, including exporting, strategic alliances and acquisitions, manufacturing considerations, marketing approaches and management considerations.

ACTIVE LEARNING CASE

Brexit troubles for Jaguar Land Rover

Before the Brexit referendum, a large number of manufacturing firms within the automotive sector were re-shoring operations to the UK. In order to save costs, firms from developed economies, such as the UK, often shift manufacturing operations to developing economies. However, due to the rise in labour costs in emerging economics, transportation costs, ease of market access and concerns over quality levels, an estimated one out of six firms, in one way or another, brought manufacturing back to the UK between 2011 and 2014. But this prosperity didn't last long and since the 2016 referendum results, the industry has been in decline. Various automotive firms with operations in the UK, such as Jaguar Land Rover (JLR), Nissan, Honda, Toyota and Mini, were challenged by the uncertainty of the Brexit process and prospect of a greater disconnect between the UK and mainland Europe.

The UK Automotive Industry

Accounting for approximately $107 billion turnover and $26 billion value added, the UK was the fourth largest nation in terms of automotive production in 2017 (see Table 16.1). Germany has continually been the leader in automotive production in Europe, Spain and France hold second and third positions respectively. In the EU, as of 2017, the UK hosted approximately 20 per cent of all automotive production plants and employed over 850,000 people across the wider British automotive industry. Moreover, the industry accounts for approximately 12 per cent of total UK exports and invests around $5.2 billion each year in automotive R&D. In total, just over 30 automotive OEMs (Original Equipment Manufacturers) produce around 70 models of vehicle in the UK. The industry in the UK is supported by 2,500 component firms who employ some of the world's most skilled engineers.

From 2009 to 2016 vehicle production in the UK increased from approximately 1 million vehicles to just over 1.7 million vehicles. Yielding an increase of around 70 per cent (700,000 vehicles), this represented significant growth in the industry within this period. From 2015 to 2016, the increase of vehicles produced by 15 UK car manufacturers was close to 8.5 per cent (1.72 million units), the highest since 1999. However, this decreased in 2017, due to the uncertain political environment (see Figure 16.1).

In terms of exports, in 2017 approximately 80 per cent (1.35 million) of the vehicles produced in the UK were exported, and 56 per cent of the total vehicles produced in the UK were exported to the EU. In Europe, with a share of 8.6 per cent and 7.2 per cent, Germany and Italy imported the largest share of automotive vehicles from the UK respectively. However, as a single nation, the US imports the largest (14.5 per cent) share of automotive vehicles from the UK. Taking these figures into account, and given Britain's pledge to leave the EU, the UK economy was not only highly dependent on the automotive industry, but also on the EU. Keeping the automotive industry stable was important to ensure a healthy trade balance.

Jaguar Land Rover

Headquartered in the West Midlands (UK), in 2018 JLR had a workforce of approximately 43,000 employees, of which the majority were employed within the UK. In 2017, they produced 532,107 vehicles, accounting for over 30 per cent of UK's total automotive production. Approximately 22,000 people were employed in the production side of the business and the remaining employees worked in Research and Development (R&D), operations, administrative and service-led capacities. Tata, an Indian conglomerate, acquired the British car manufacturer from Ford in 2008. With the help of Tata, JLR restructured its business, with a focus on financial management, and within five years of the $1.5 billion acquisition, JLR had turned its fortunes around. The so-called 'steal of the decade' became something of a celebrated success story, until Brexit and a number of other global shifts started to work against the car firm.

Table 16.1 European automotive manufacturers, 2017

Rank	Country	Cars	Commercial Vehicles	Total	% change
1	Germany	5,645,581	0	5,645.581	−1.76%
2	Spain	2,291,492	556,843	2,848,335	−1.30%
3	France	1,748,000	479,000	2,227,000	6.54%
4	UK	1,671,166	78,219	1,749,385	−3.70%
5	Czech Rep.	1,413,881	6,112	1,419,993	0.00%
6	Italy	742,642	399,568	1,142,210	3.53%
7	Slovakia	1,001,520	0	1,001,520	−3.70%
8	Poland	514,700	175,029	689,789	1.16%
9	Hungary	502,000	3,400	505,400	−4.01%
10	Belgium	336,000	43,140	379,140	−5.08%

Source: SMMT (https://www.smmt.co.uk/wp-content/uploads/sites/2/SMMT-Motor-Industry-Facts-June-2018.pdf).

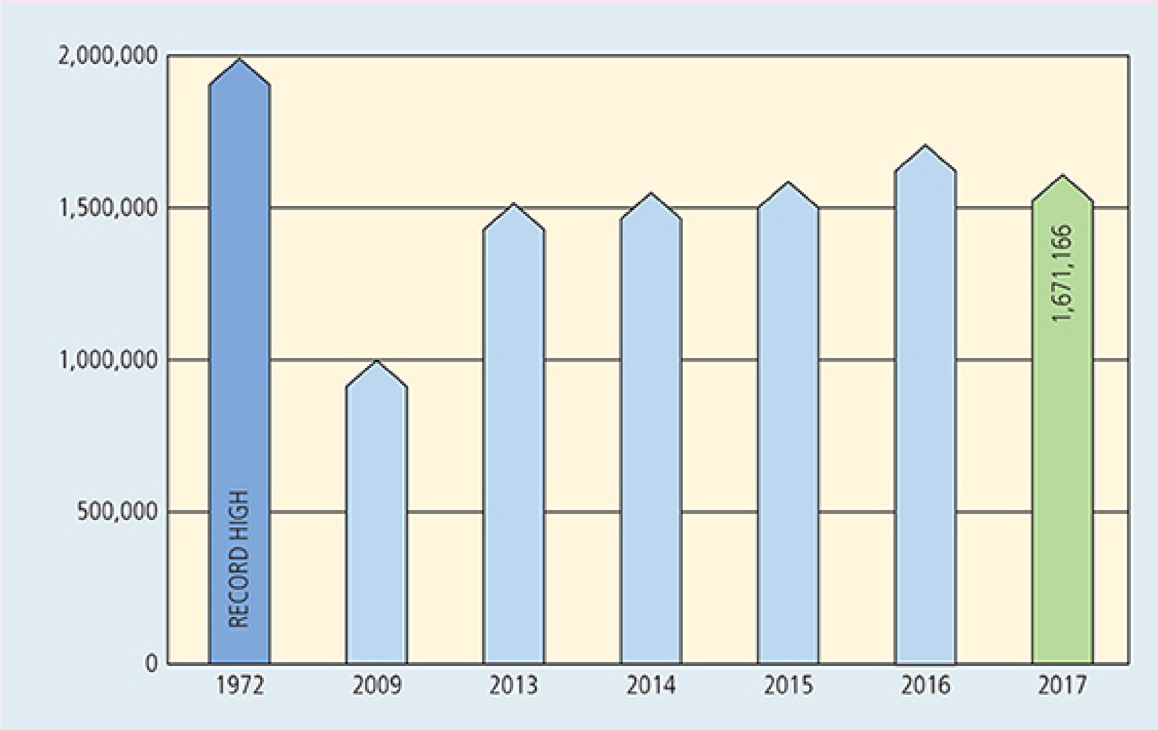

Figure 16.1 UK automotive vehicle production, 2013–17

Source: SMMT (https://www.smmt.co.uk/wp-content/uploads/sites/2/SMMT-Motor-Industry-Facts-June-2018.pdf).

According to 2017 research for the Automotive Council British auto sector, the UK automotive industry sources around 56 per cent of parts internationally, with a large proportion coming from Europe. In 2018 JLR was building around 3,000 cars a day in four production and engine plants, using 25 million components, of which about 40 per cent (by value) were imported from Europe (see Figure 16.2).

The Brexit process was in full swing by 2019 and JLR were facing the likelihood of significant increases in tariff and non-tariff barriers for components and final products, coming into and out of the UK. Without a Brexit trade deal, automotive cars produced in the UK would be subject to WTO tariffs of 10 per cent, which make them significantly more expensive for the end customer. Although this may encourage automotive firms to adjust their supply chains so that components are sourced

domestically, not all components could be made in the UK due to shortages in skills and raw materials. Any decision by manufacturers to offshore production would disproportionately affect manufacturing regions with high levels of trade dependency with Europe, including the West Midlands. The significance of the industry to this, and other manufacturing regions, extended beyond employment. A downturn in automotive investment would affect the prospects for innovation hubs in transport and energy technologies and the long-run competitiveness of the UK.

In terms of employment, shifting production to other countries would only make sense in the event of significant tariffs. However, European suppliers located in automotive clusters already possessed a skilled workforce and were already engaged in volume savings initiatives. One estimate at that time suggested that the added costs of manufacturing components in the UK post-Brexit would mean that the cost of producing 50,000 components in the UK would exceed the costs of producing 1 million equivalent components in Poland. This cost margin applied even to fairly sophisticated components, such as electronic control units. These act as the brain of the modern vehicle and control things such as steer assistance, automatic breaking, navigation systems, etc. Although high-technology products tend to be associated with developed countries, these electronic products are actually assembled in low-cost markets. In Europe, these products are generally assembled in Romania, where labour costs are significantly cheaper than the UK.

Some supply chain experts claimed that producing more automotive goods in the UK may be worth it to manage some of the political risks associated with Brexit. But for most firms, responding to this kind of political uncertainty, with a complex range of potential outcomes, means delaying investment decisions or cutting costs in preparation for worst-case scenarios. It can also provide 'cover' for other problems which firms are facing, including challenges which have resulted from poor management decisions, rather than external events.

In 2018, JLR announced it would axe around 4,500–5,000 production jobs. Because these jobs created 'multiplier' effects in the West Midlands region, through employee spending in shops and restaurants and other services, as well as through JLR's local suppliers, there would be a knock-on effect of such job losses. One estimate suggests that 2.5 additional jobs would be lost for every one JLR manufacturing plant redundancy, with widespread implications for the regional economy.

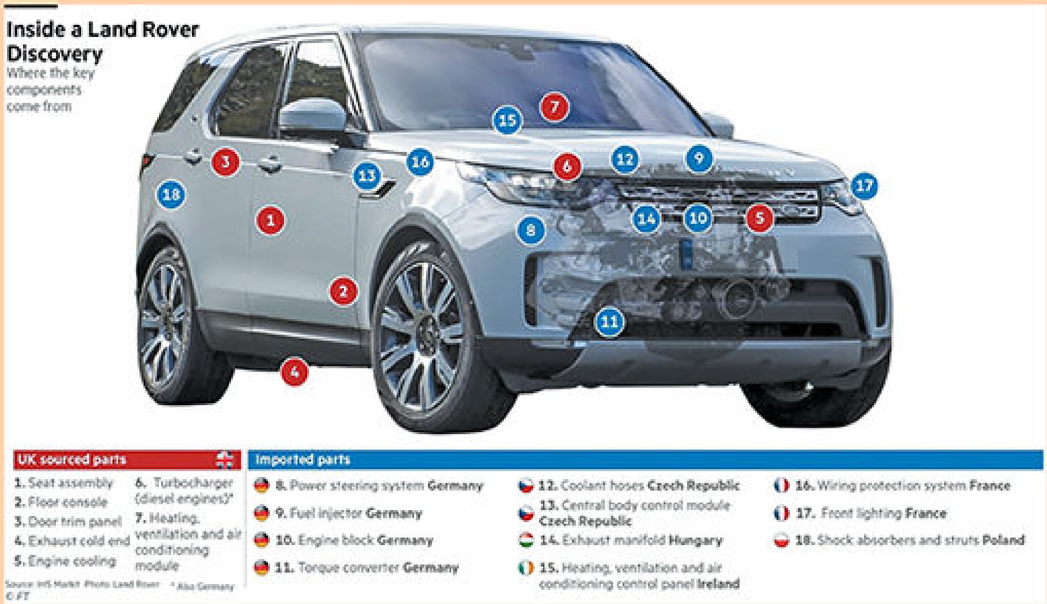

Figure 16.2 **Key components in an average Land Rover Discovery**

Source: Peter Campbell and Michael Pooler JULY 30 2017, Brexit triggers a great car parts race for UK auto industry. Reterived from https://www.ft.com/content/b56d0936-6ae0-11e7-bfeb-33fe0c5b7eaa.

But Brexit uncertainties were only one factor driving JLR's restructuring. Poor sales performance in key countries, particularly China, alongside a slower transition away from diesel cars to hybrid and electric models also had an impact. In the first quarter of 2019 the firm's retail sales were down 13.3 per cent compared to the previous year. In particular, sales in China were down by over 45 per cent, compared to a decline of 22 per cent in other overseas markets and just 5.5 per cent in Europe. This partly justified a shift of some production to Eastern Europe.

Other UK-based car manufacturers were facing the same pressures, with Brexit uncertainties providing a tipping point for some to change their international production structures. BMW's Mini, also had production plants in the UK and also announced protection measures in the event of a hard Brexit. In 2017, BMW produced around 220,000 vehicles at its Oxford plant, which accounted for

13 per cent of the UK's total car production. The German manufacturer issued long stoppages of its manufacturing plant in Oxford, which was meant to be the place where the electric Mini was built. More significantly, in 2018 Honda confirmed it would end operations at its Swindon factory by 2021, after almost three decades of investment. This would result in 3,500 direct job losses and at least another 3,500 redundancies across the supply chain.

In the 1950s the UK car industry was a global leader, second only to the US in terms of volume of production, with many key product technologies and process innovations originating in the West Midlands. Manufacturing spread globally and British firms gave way to foreign-owned multinationals producing in the UK. Through various cycles of resurgence and decline, it remains a leading centre for high-performance technology and F1 engineering. But this latest cycle of job-cuts and off-shoring, triggered partly by Brexit, may be the start of the end of automotive mass production in the UK.

Websites: https://www.telegraph.co.uk/business/2019/05/11/fall-rise-fall-jaguar-land-rover/; https://www.thebusinessdesk.com/northwest/news/2041672-tough-month-hits-jlr-as-takeover-rumours-abound; https://europe.autonews.com/article/20180920/ANE/180929995/jlr-faces-fresh-brexit-dilemma-over-uk-built-parts; https://autovistagroup.com/news-and-insights/jlr-and-mini-voice-concerns-over-parts-supply-post-brexit; https://www.ft.com/content/b56d0936-6ae0-11e7-bfeb-33fe0c5b7eaa; https://www.theguardian.com/business/2019/may/13/honda-close-swindon-plant-ending-workers-hopes; https://www.smmt.co.uk/wp-content/uploads/sites/2/SMMT-Motor-Industry-Facts-June-2018.pdf;

Sources: Qamar, A. (2016). 'Re-shoring within the UK manufacturing industry: an inevitable decline?' *Dissident Voices in Europe? Past, Present and Future*, pp. 3-16.

1. **Evaluate the state of the UK automotive industry both before and after the 2016 Brexit referendum.**
2. **How would JLR benefit if the UK stayed in the EU?**
3. **How dependent is the UK economy on the automotive industry and how dependent is the UK automotive industry on the EU?**

4 **Discuss whether JLR are likely to re-shore or offshore production after the UK leaves the EU.**

THE EU: ORIGINS AND ENVIRONMENT

The EU currently consists of 28 countries (see Figure 16.3). These comprise the pre-2004 EU15, ten other European countries that joined in 2004, Bulgaria and Romania which joined in 2007, and Croatia that joined in 2013. The EU15 are closely linked both economically and politically, and this group is more loosely linked to the 13 new members. In terms of monetary policy, 12 of the pre-2004 EU15 share a common currency, the euro, and constitute the Eurozone. Today, the EU28 has a population of almost 513 million and generates US$18.8 trillion nominal GDP. Doing business in this bloc offers huge opportunities, and many MNEs are interested in tapping this giant potential (see Table 16.2).

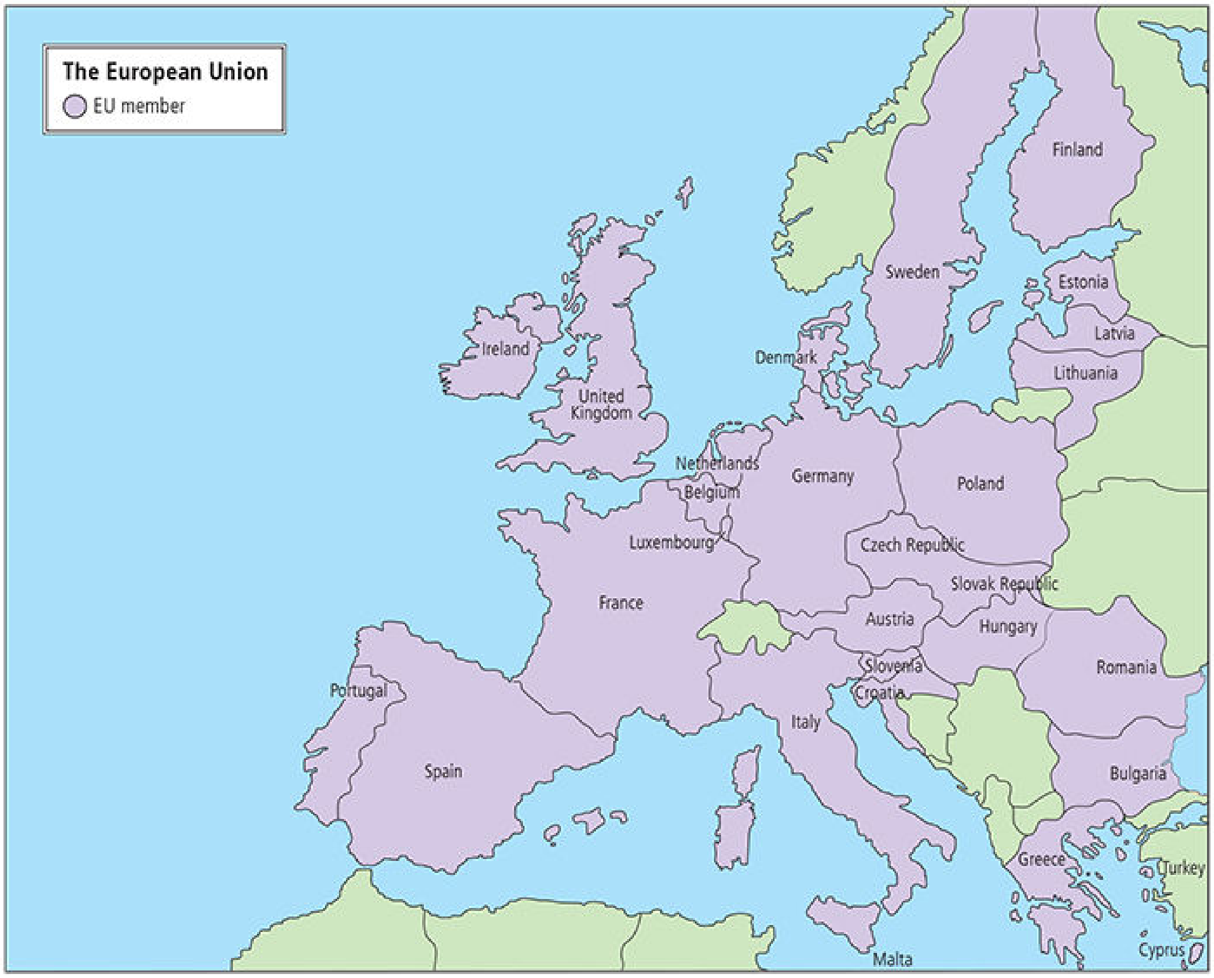

Figure 16.3 **The European Union**

Table 16.2 **Economic profile of the USA, Japan and the EU (in US$), 2018**

	US	JAPAN	EU28
The economy			
GDP	20.49 trillion	4.97 trillion	18.8 trillion
Real GDP growth rate	4.2%	0.3%	2.4% (2017)
Inflation	1.9%	0.3%	1.7%
Workforce			
Population	327 million	127 million	513 million
Population below poverty line	12.3% (2017)	16% (est.2016)	17.3% (2015 est.)
Labour cost per hour in manufacturing	39.03 (2016)	26.46 (2016)	30.16 (2018)
Unemployment rate	4.1%	2.5%	6.5%
Merchandise trade			
Trade balance	(891.3 billion)	(11 billion)	(26.7 billion)
Exports	2.5 trillion	733 billion	2.31 trillion
Imports	3.1 trillion	744 billion	2.33 trillion
Public sector			
Government spending as % of GDP	38.0%	39.3%	45.8%
Government debt as % of GDP	106%	200.5%	85.1%

Sources: https://www.cia.gov/index.html; http://www.bls.gov/ilc/#laborforce; https://ec.europa.eu/eurostat/; https://www.statista.com; https://stats.oecd.org/.

A growing range of new threats and opportunities have challenged the political and economic cohesion of the EU in recent years. The growing flow of migrants from Africa and the Middle East, particularly Syria, threatened those countries located at the borders of the EU, such as Turkey and Greece, which had already gone through a series of economic and political upheavals (see the case **International Business Strategy in Action: Greece** in Chapter 4). This triggered heated debate and revealed both a lack of political unification and a lack of a coordinated operational response to the crisis. At the same time the UK, pushing for a range of reforms to further distance itself from the economic, social, and political union, held a referendum to decide whether it should exit ('Brexit') the EU altogether. In 2016 the UK voted, by a narrow margin, to leave the EU. But by 2019 it had still failed to agree the terms of its exit and these uncertainties added to other tensions within the EU to threaten its overall future (see the **International Business Strategy in Action: Brexit: A sharp lesson in the importance of trade interdependencies** in Chapter 6).

Active learning check

Review your answer to Active Learning Case question 1 and make any changes you like. Then compare your answer to the one below.

1. **Evaluate the state of the UK automotive industry both before and after the 2016 Brexit referendum.**

The UK automotive industry was the fourth largest nation in terms of automotive production in 2017 and before the 2016 Brexit referendum; the industry was performing well with clear growth. For instance, from 2009 to 2016 vehicle output increased from approximately 1 million vehicles to just over 1.7 million vehicles, representing growth of around 70 per cent. One year before the referendum, the industry achieved an annual growth rate close to 8.5 per cent (1.72 million units), the highest since 1999. However, one year after the referendum the growth quickly transitioned into decline to minus 3.7 per cent in 2017. Mass manufacturers such as JLR, Mini and Honda were impacted given the economic uncertainty surrounding Brexit. JLR announced a cut of 4,500–5,000 production jobs in the UK, Mini halted production for intermittent periods at its manufacturing plant in Oxford, and Honda confirmed that it would end all operations at its Swindon factory by 2021. Considering the notion of multipliers, and given these job losses, these strategies would have consequences for thousands of jobs within the UK automotive supply chain. Although the industry hosts high value R&D and technology, the latest cycle of job cuts may be the start of the demise of mass production in the UK automotive industry.

For France Telecom to be able to purchase rival firms, deregulation of the telecommunications markets of individual countries in the EU had to occur. In addition, France Telecom's acquisitions had to overcome antitrust legislation in the EU. The development of the EU Single Market and the strengthening of the competition policy to dismantle protectionist borders within the EU helped France Telecom evolve into Orange.

Emergence of a Single European Market

The origins of the EU go back to the formation of the European Economic Community (EEC) in the late 1950s, at which time there were six founding members: France, West Germany, Italy, Belgium, the Netherlands and Luxembourg. Over most of this time economic growth and a shared regional security agenda has led to a high degree of political and social integration.

The objectives of the EU are:

1. Elimination of customs duties among member states.
2. Elimination of obstacles to the free flow of import and/or export of goods and services among member states.
3. Establishment of common customs duties and unified industrial/commercial policies regarding countries outside the community.
4. Free movement of people and capital within the bloc.
5. Acceptance of common agricultural policies, transport policies, technical standards, health and safety regulations, and educational degrees.
6. Common measures for consumer protection.
7. Common laws to maintain competition throughout the community and to fight monopolies or illegal cartels.
8. Regional funds to encourage the economic development of certain countries/regions.
9. Greater monetary and fiscal coordination among member states and certain common monetary/fiscal policies.[1]

In December 1985, EU leaders adopted a White Paper that contained 279 proposals aimed at achieving a single unified European market by 31 December 1992. Less than two years later the Single European Act (SEA) was passed. A key part of the SEA was the EU **Council of Ministers**, one of the four major institutions of the EU. For each field of discussion, the EU

Council of Ministers consists of one minister from each of the member states and is responsible for making major policy decisions for the union. The Council could now pass most proposals with a majority vote, in contrast to the unanimous vote needed previously. This opened the door for much faster progress towards both political and economic integration among member countries. Twelve of the EU15 countries have now adopted a single European currency, the euro, and have committed to a social charter, complete harmonisation of social and economic policies, a common defence policy and related measures that increase the power of the EU bureaucracy in Brussels. The Treaty of Lisbon, which came into force in 2009, was the last amendment to the constitutional basis of the EU. It provided for a greater role for the European Parliament and more ways for national governments and individual citizens to be involved in EU policy making.

Will the EU eventually bring about a **Single European Market (SEM)** in which the above stated goals are achieved? This will depend on the extent of progress in the area of free movement of goods and the practice of government procurement. It will also depend on whether the new member countries, and any others that join in the future, can be harmoniously integrated. But this looks less likely now that the UK has decided to leave.

Free movement of goods

There have been no customs duties between most EU members since 1 March 1986. Most technical, safety and other standards and regulations for trade have now been standardised throughout the EU. However, free movement of goods has been hampered by fragmented local markets. This fragmentation has been created by exploiting language differences between countries and by setting artificially high prices for goods. With the growth of discount stores, mail-order houses, cross-border buying deals and e-commerce, these differences are gradually being eliminated.

The EU has also created a single currency, the euro, which some believe is beginning to challenge the US dollar's dominance of international trade and finance. In January 2002, the euro officially replaced individual countries' currencies in 12 member states. This had extended to 19 countries in the 'Eurozone' by 2014, by which time it had the highest combined value of cash in circulation in the world, surpassing the US dollar. Some key countries, notably the UK, have not joined the single currency community and full financial integration across Europe has proved complex. But the process of financial integration has helped generate new opportunities for both EU businesses and foreign MNEs doing business there.

Practice of government procurement

EU government procurements account for 17 per cent of the union's GDP. In the past it has been common to find governments awarding contracts to national firms. However, with the emergence of the SEM and the Government Procurement Agreement (GPA), this is diminishing. The result will be greater efficiency, lower cost and an economically stronger common market. On the other hand, it is important to realise that, in implementing this strategy, many companies are likely to find themselves losing business to competitors in other EU countries that can provide higher quality and service and lower cost. This development will also probably be somewhat slow in coming because of the possible negative impact of the economic growth of individual countries and the desire to favour national firms when awarding government contracts.

Meanwhile, the EU continues to try to improve cross-border access to government procurement contracts. It has sought to standardise the procurement process to overcome language barriers. For example, the European Commission has proposed a common vocabulary to be used in all public procurement notices that would standardise the procurement process and increase competition.

Enlargement of the EU

The accession of additional members into the EU since 2004 has changed the panorama of the union and raised questions about the feasibility of a truly integrated region, economically and politically. With the exception of the war on Iraq, the EU15 had been able to maintain a relatively common front in regard to foreign policy. The Union has also been able to present a unified stance on a number of other international matters, including aid to poorer nations and other wars. While all countries are broadly ‘Western capitalist democracies’ there is a wide variation in the kinds of capitalism practised, linked to historical, cultural and geographical differences. The UK is closest to a US-style of market capitalism, more shareholder than stakeholder-oriented emphasising entrepreneurship and competition. France and Germany are more stakeholder-oriented with an emphasis on more ‘patient’ long-term investment and stronger social support systems. Moreover, some central European nations are more aligned historically with Russia.

Further enlargement also threatens to increase the differences among member countries, stymieing political and economic integration. In particular, the possibility that Turkey might join the union has created a lot of tension within the EU. Turkey’s mainly Islamic population is relatively large, and the country has a relatively younger population that could have an impact on the political future of the aging EU. Many nationalist groups within the EU are against Turkey joining the union and, indeed, see any further enlargement as a dilution of their power within the union. It is difficult to predict whether the EU28 has the potential to be as integrated politically and economically as the EU15 did. For the time being, however, there is internal disagreement about further integration.

Active learning check

Review your answer to Active Learning Case question 2 and make any changes you like. Then compare your answer to the one below.

2 How would JLR benefit if the UK stayed in the EU?

EU members are free from obstacles that prohibit the free flow of import/export of goods and services among member states. Without a Brexit trade deal, automotive cars produced in the UK would be subject to WTO projected tariffs of close to 10 per cent on all finished vehicles. This would make JLR's vehicles significantly more expensive for the end customer. If the UK were to remain in the EU, then JLR would not have to pay tariffs on approximately 10 million components per day, which are sourced from the EU. Although being exempt form tariffs would certainly help JLR maintain a competitive position in today's global automotive market, a vital form of costs when doing business across nations actually tend to be in the form of non-tariff barriers, which include: rules-of-origin checks; customs controls; compliance with different product standards and regulations between countries. Remaining in the EU would mean that firms like JLR would face fewer operational complexities. These non-tariff barriers are not only time consuming, but they mean that JLR will find it very difficult to implement initiatives such as just-in-time, which is one of the key operational requirements for large automotive firms. Delay in the delivery of components is said to cost JLR $1.6 million per hour. Moreover, shortages in skills is an issue within the automotive industry. If the UK remained in the EU, the movement of skilled labour from Europe would be difficult to achieve.

PRODUCTIVITY AND COMPETITIVENESS: HOW DOES THE EU COMPARE?

An integrated EU arguably would help greater Europe compete more effectively with China and the USA, or the Asian and North America triad groups. However, there is significant variation in the national cultures, institutions, capital markets, infrastructures, skills and business practices and therefore the existing national competitive advantages and disadvantages across the EU.

Productivity

Productivity is a measure of efficiency, or the rate at which a firm or country produces outputs of products and services. It can be defined as GDP (Gross Domestic Product) or GVA (Gross Value Added) per person and represents the value added to a product or a service (indicated by its price) taking into account costs. Highly productive economies are more competitive and this can translate into export competitiveness.

Capital investment and the level of automation, the availability of skills, wage levels, the structure of production and more broadly, infrastructure, employment laws, public sector and social services are all factors which affect productivity at the levels of the firm, region and country. Labour laws, particularly in Germany, France and Northern European countries make it more difficult to fire employees, compared to the US and other countries. This enables firms in the US to hire and fire more quickly, in response to external opportunities and threats, but it also reduces investment in training and increases socio-economic inequalities. Japanese firms tend to treat their workers as a fixed cost and so find the practice of firing to be unnecessary, or

more difficult. They spend more on training and development and employees tend to be more loyal and work harder, with a stronger dedication to improving their own skills and the firm's performance.

As shown in Figure 16.4, hourly compensation costs for production workers in manufacturing were higher in Germany and many Northern European countries than in the United States. But costs were much lower in Japan and most other OECD and emerging market economies.

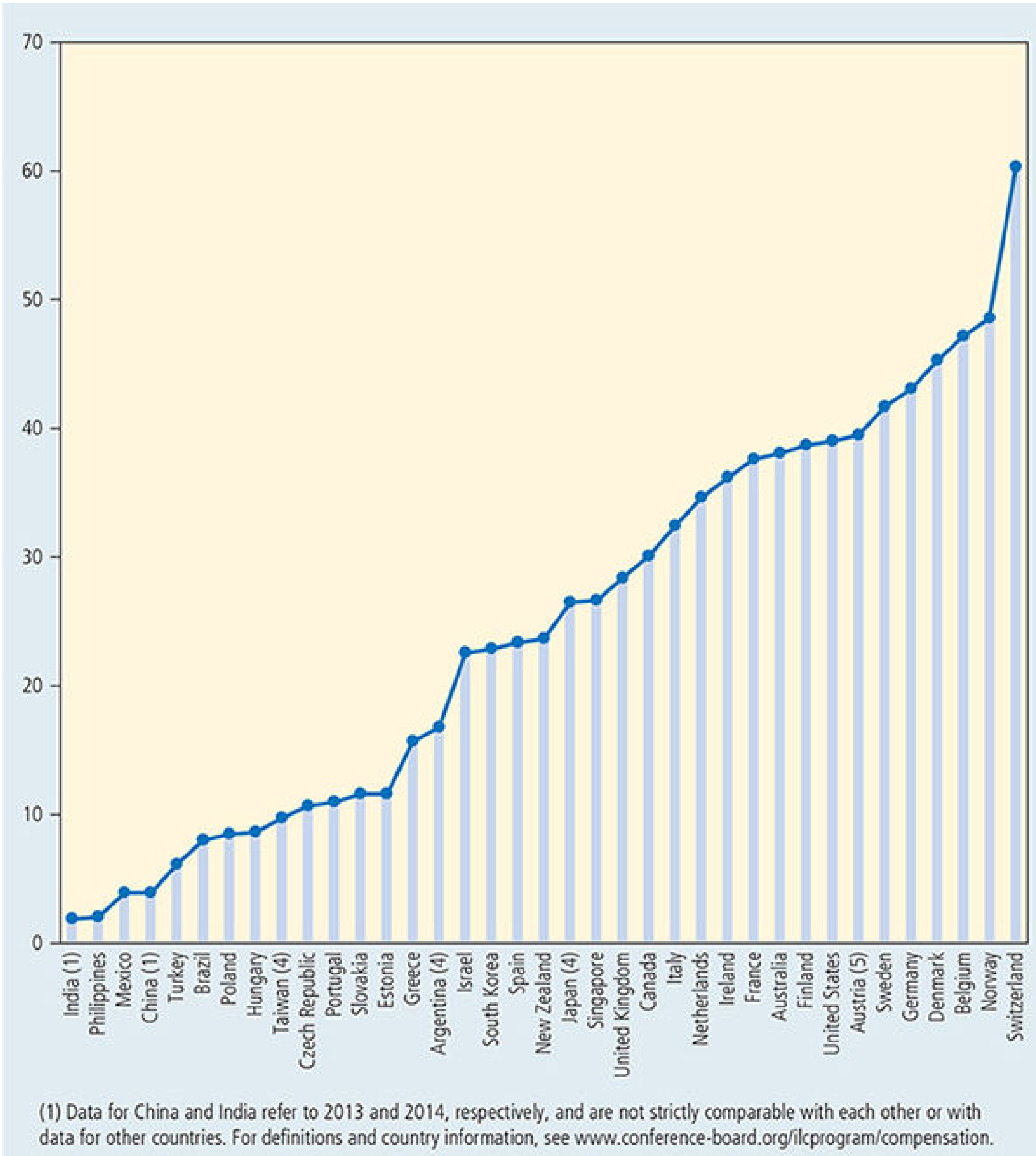

Figure 16.4 Hourly compensation costs in manufacturing, US dollars, 2016

Source: https://www.conference-board.org/ilcprogram/index.cfm?id=44891#Chart1.

If we look at relative levels of productivity, however (Figure 16.5), the US has one of the highest levels and Japan has one of the lowest in the OECD. The US therefore manages to achieve higher productivity levels than countries with cheaper labour and this is partly due to economies of scale,

better management practices and more automation in key sectors, all leading to better efficiency. France and particularly Germany have higher-than-average labour costs and productivity levels that are also higher than both the OECD average and the UK. Cheaper labour rates in the UK do not translate into relatively higher productivity levels, partly because of lower average skills levels (particularly among low-income groups), weak infrastructure in some regions and the structure of the economy. But, like the US and other countries there is significant within-country variation in the UK, with London and the South-East achieving high productivity levels and other regions doing less well.

Investment spending and education

Two important factors influencing productivity and therefore national competitive advantage are investment spending and education. Both of these occur at the national level and the firm level. National investment in infrastructure helps labour mobility and supports efficient supply chains, transportation and communications. Similarly, national systems of education are critical to the development of skilled workforces. At the firm level investment in fixed assets, capital equipment, innovation and new technology also improves productivity. Alongside this the most competitive firms invest in employee training and development to improve skills and expertise across all levels of employee.

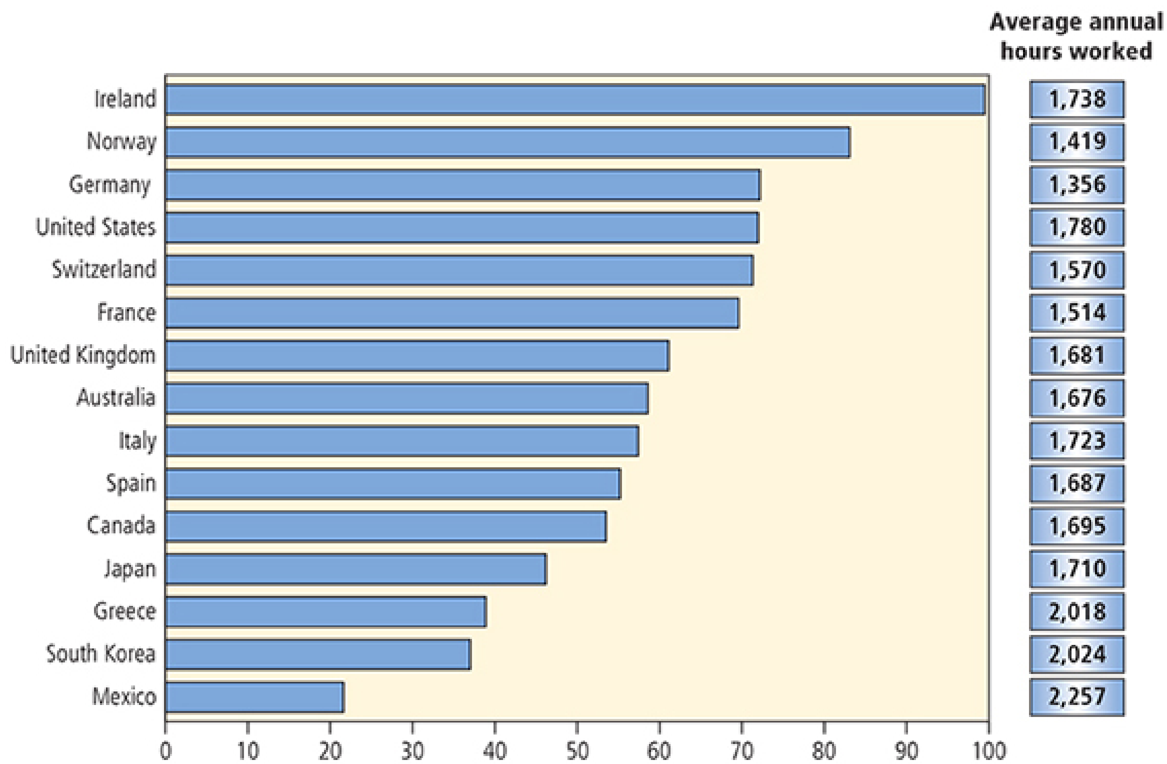

Figure 16.5 Where labour productivity is highest, 2017

Source: https://static.electronicsweekly.com/wp-content/uploads/2019/02/06155812/D2385A1A-5836-4CC8-A529-1750BEF376E8.jpeg.

Investment spending in EU countries is hugely variable as it is both an input and an output of successful economic growth. Balancing the public and private sectors of the economy, maintaining efficient capital markets, creating policies to selectively invest in R&D, entrepreneurship and new technologies are all part of the competitiveness challenge. The EU provides a strong, central set of institutions and funding mechanisms to support some of these ‘market interventions’ and creates some economies of scale, for example in scientific research to benefit all members.

The OECD countries spend approximately 10 per cent of GDP on education, but their approaches are different. In Europe, most vocational training is provided at the high school level, whereas in the United States and Japan it comes later. In the United States and in the UK a higher percentage of

the population attends university or college than in other parts of Europe or Japan. The European university curriculum is arguably more theoretical and less applied than in other countries and the effects of this on competitiveness are strongly debated. Some argue that high youth unemployment rates are the result of the European education system.

Overall evaluation

In overall terms, the EU has traditionally lagged behind its triad competitors, although recent downturns in the US economy contrast with sustained growth in some EU countries, including many in the south. Table 16.3 shows the changes in competitiveness across a range of EU countries, compared to their counterparts elsewhere. In 1989, all the EU15 countries ranked in the top 22 most competitive economies in the world. There has been a steady decline in this number as newly emerging economies from Asia and elsewhere joined the top ranks. The world is becoming a more competitive place, and some EU countries are finding it hard to keep up.

Table 16.3 The world's most competitive economies

Rank	1989	2008	2014	2018
1	Japan	United States	Switzerland	United States
2	Switzerland	Switzerland	Singapore	Singapore
3	United States	Denmark	United States	Germany
4	Canada	Sweden	Finland	Switzerland
5	Germany	Germany	Germany	Japan
6	Finland	Finland	Japan	Netherlands
7	Netherlands	Singapore	Hong Kong SAR (P.R. China)	Hong Kong SAR (P.R. China)
8	Sweden	Japan	Netherlands	United Kingdom
9	Norway	United Kingdom	United Kingdom	Sweden
10	Australia	Netherlands	Sweden	Denmark
11	United Kingdom	Korea	Norway	Finland
12	Denmark	Hong Kong SAR (P.R. China)	United Arab Emirates	Canada
13	France	Canada	Denmark	Taiwan (Province of China)
14	Belgium/Luxembourg	Taiwan (Province of China)	Taiwan (Province of China)	Australia
15	Austria	Austria	Canada	South Korea
16	Ireland	Norway	Qatar	Norway
17	New Zealand	Israel	New Zealand	France
18	Spain	France	Belgium	New Zealand
19	Italy	Australia	Luxembourg	Luxembourg
20	Turkey	Belgium	Malaysia	Israel
21	Portugal	Malaysia	Austria	Belgium
22	Greece	Ireland	Australia	Austria

Source: Adapted from IMD and World Economic Forum, *The World Competitiveness Report*, 1989, 2008, 2014 and 2018.

INTERNATIONAL BUSINESS STRATEGY IN ACTION

VW diesel dispute

Established in 1937, the Volkswagen (VW AG) Group is a German multinational automotive enterprise with its headquarters in Wolfsburg, Germany, and subsidiary divisions for the design and manufacture of passenger and commercial vehicles, motorcycles, engines, turbomachinery and financial services. In 2018 it recorded revenues of $264 billion and employed around 655,000 people. The VW AG group is comprised of many automotive manufacturers such as Audi, Bentley, Lamborghini, Porsche, SEAT and Skoda. As of 2014, VW was the second largest automaker in the world, just behind Toyota.

In 2015 the VW Group faced a scandal, dubbed the 'diesel dispute', which directly contradicted the company's long-standing values and medium-term strategy: 'Our pursuit of innovation and perfection and our responsible approach will help to make us the world's leading automaker by 2018 – both economically and ecologically.' The Environmental Protection Agency (EPA) found that many vehicles sold in the US, spanning a range of models (Audi A3, Jetta, Beetle, Golf), were fitted with a device within the diesel engine that could detect when they were being tested and which, in turn, adjusted the performance in order to improve the results. With a large marketing campaign emphasising low diesel emissions, VW had been pushing to sell vast number of vehicles in the US. However, with findings covering 482,000 vehicles in the US, the EPA found that VW had been fitting this so-called 'defeat device' within all its diesel vehicles.

Acknowledging these allegations, the VW Group held its hands up and further admitted that approximately 11 million vehicles sold worldwide had also been fitted with this device. The company was accused not only of cheating the emissions test, but of cheating customers who had bought cars they believed were environmentally friendly. Why had this happened and for how long had it been going on within VW?

Leadership

Following the emergence of these allegations, Martin Winterkorn, who was appointed CEO in 2007, resigned from the organisation and was replaced with Matthias Mueller, who was the former boss of Porsche. This, however, was the latest move in a long history of politics and power-play at the top of

one of Europe's largest MNEs. For some observers the origins of the scandal can be traced back to 2005, where Winterkorn's predecessor, Bernd Pischetsrieder, and head of VW, Wolfgang Bernhard, were in control of the organisation. However, both have claimed their innocence and investigations are turning to the employees hired within the last decade in order to resolve the matter.

The diesel scandal is not the only recent scandal to hit VW, as in 2004 Bernhard was caught in the middle of a bribery scandal concerning payments, which resulted in the resignation of VW's personnel director. Following the bribery scandal, Pischetsrieder and Bernhard attempted to reform the organisation in two ways. Firstly, the duo reduced costs within manufacturing bases and emphasised an end to certain labour practices, such as the four-day, 29-hour working week. Secondly, they attempted to reform the organisation's culture, focusing on the relationship between management and the works council. However, this proved to be more challenging than initially imagined, as the duo constantly faced a power struggle which resulted in VW's chairman, Ferdinand Piëch, teaming up with labour representatives to remove Pischetsrieder from his post. Winterkorn replaced Pischetsrieder as CEO and Bernhard left the organisation only a few months after the appointment of Winterkorn. Multiple executives and directors have stated that Winterkorn seemed to adopt a culture in which success was down to his own doing and any bad news was pinned on the former leadership duo.

Engine development

Multiple board members repeatedly suggested that the origins of the diesel dispute can be traced back to 2005, when VW identified a gap in the US diesel market and aimed to target the United States as heavily as possible. However, VW's problem lay in the fact that it did not have a diesel engine which met US vehicle standards. Furthermore, VW went on to withdraw existing diesel models in 2006, as they did not comply with the US's new Tier 2 vehicle standards.

With the aim of developing a new engine that could be used to tap into the US market by 2008, Bernhard appointed Audi's engine developer, Rudolf Krebs, to take on the challenge. But the two quickly came to realise that using a fuel injection system called Pumpe Düse, which was the way VW usually made engines, was not going to work. In order to overcome this obstacle, Bernhard switched to using Mercedes' (his former firm) technology, known as AdBlue. This change in engine technology was seen as controversial, as it did not complement VW's in-house expertise. The

adoption of the AdBlue system was put aside, however, when VW appointed Winterkorn as CEO in 2007. He put VW firmly on course to develop the lean NOx trap system in order to reduce emissions. Furthermore, Winterkorn promoted Ulrich Hackenberg and Wolfgang Hatz to take charge of engine and transmission, both of whom were suspended when the diesel dispute hit the headlines.

Who is to blame?

Former employees have stated that 2008 was the critical time in which VW management would have been accountable for the scandal, as this was the year in which VW's engine and software were certified. In addition, former employees have also stated that there would have been multiple occasions for executives to notice that the software team was doubling its workload in terms of programming the engine to act differently when being tested and actually driven. So even though it is possible that a small team of managers may have orchestrated the defect device in order to develop an engine suitable for the US market, arguably management within VW should still be blamed as they were ultimately responsible for the actions of these engineers. It is also difficult to believe that a couple of rogue engineers would have taken it upon themselves to write a software programme that reduced emissions when being tested, without the senior members of the team finding out. In 2018, German prosecutors charged Martin Winterkorn, the former chief executive who quickly resigned following the outbreak of the emissions scandal. As of 2019, reportedly the costs of the emissions scandal exceeded $30 billion. Moreover, in 2019, automotive supplier Bosch was also held accountable, as the technology used within the cheating device was made possible via the assistance of Bosch technology. Given this, Bosch, agreed to pay approximately $100 million in fines.

Conclusion

Volkswagen's scandal had immediate effects on the organisation's reputation and sales. It lost ground to multiple competitors, as shown by Volkswagen's fall in market share across the EU from 26.5 per cent in August to 23.3 per cent in September 2015. VW remains the market leader in some segments with brands such as Porsche, Audi, Skoda and SEAT still showing signs of growth. But the company has lost the trust it enjoyed among customers as well as regulators and environmentalists – some of them long-standing, loyal believers in the integrity of the VW brand. The leadership faces the

challenge of devising a strategy that not only fixes the engine issues, but also creates a culture that wins back trust from both employees and consumers.

Sources: Volkswagen, *Annual Report*, 2015, 2018; R. Hotten, 'Volkswagen: the scandal explained', *BBC News*, 10 December 2015; 'VW crisis: 'Fewer than 10' targeted in emissions probe', *BBC News*, 16 October 2015; P. Kedrosky, 'An engineering theory of the Volkswagen scandal', *New Yorker*, 16 October 2015; J. Kollewe, 'Volkswagen market share declines in September', *Guardian*, 16 October 2015; R. Milne, 'Culture clash gives clue to Volkswagen scandal', *Financial Times*, 6 October 2015; J. Rankin, 'VW rejects call to compensate European drivers over emissions scandal', *Guardian*, 21 January 2016; Patrick McGee, 'Volkswagen gears up for AGM showdown with investors', *Financial Times*, 12 May 2019; Andrew Krok, 'Germany slaps Bosch with $100 million fine for role in Diesegate', *CNET*, 23 May 2019.

ACCESSING AND ADAPTING TO EU MARKETS

The European Union is the largest market in the and previous Chapters (particularly 6 and 10) have examined its position within the dynamics of global trade. Table 16.4 below provides an overview of the volume of trade between the EU other single country economies. But but despite the overarching institutions of the EU and the principle of the ‘single market’, the ease of market access for foreign firms varies by industry and country location. The most important location factors tend to be: (1) access to customers; (2) quality of labour; (3) expansion prospects; (4) level of wage costs; (5) attractive environment; (6) access to suppliers; (7) non-financial regional assistance; (8) absence of restrictions for expansion; (9) infrastructure; (10) level of rents; and (11) public transportation.

Another factor often mentioned is the ease with which a company that is not doing well can withdraw. This includes laying off workers, selling facilities and other factors involved in exiting a market. Gathering location data and understanding negotiating terms can take a considerable amount of time, but the results often justify the investment. A great deal of useful and accessible data for market-entry evaluation is now online. The World Bank’s Doing Business website provides an interactive analysis comparing countries around the world in terms of the relative ease and costs of opening, operating and closing businesses. See Chapter 14 for more detail on these factors and the relative rankings of different countries.

Regional incentives

Investment incentives take a number of forms, including grants, low-interest loans, reduced land prices and training support for personnel. For example, both Poland and Slovakia offered incentives to the auto makers Kia and JLR (Jaguar Land Rover) to lure investment for a new manufacturing facilities. The Czech Republic attracted a large amount of automotive FDI in the mid-2000s and began to supplement manufacturing investment with FDI in services and R&D. It then focused on attracting biotechnology firms to set up a cluster near Prague. The country's investment-promotion agency and other government departments use tax incentives and cheap loans to attract such investments. These extend the existing advantages of cheap land and labour (relative to western Europe) as well as access to the growing markets of eastern and central Europe.

Typically, incentives are higher when (1) the region is economically depressed, (2) many jobs are being created, (3) the company is making a large investment, and/or (4) the investment is likely to attract other investors. Before agreeing to any contract, however, it is important that the deal be 'locked in' and that any repayment of subsidies be made clear up front.

Active learning check

Review your answer to Active Learning Case question 3 and make any changes you like. Then compare your answer with the one below.

3 How dependent is the UK economy on the automotive industry and how dependent is the UK automotive industry on the EU?

As of 2017, the UK automotive industry employed over 850,000 people. The industry accounts for approximately 12 per cent of total UK exports and invests around $5.2 billion each year in automotive R&D. In terms of exports, in 2017 approximately 80 per cent (1.35 million) of the vehicles produced in the UK were exported, and 56 per cent of the total vehicles produced in the UK were exported to the EU. In Europe, Germany and Italy imported the largest share of automotive vehicles from the UK, with shares of 8.6 per cent and 7.2 per cent respectively. However, as a single nation, the US imports the largest (14.5 per cent) share of automotive vehicles from the UK. Taking these figures into account, and given Britain's pledge to leave the EU, the UK economy is not only highly dependent on the automotive industry, but also on the EU. Keeping the automotive industry stable is important to ensure a healthy trade balance.

Conducting export operations

In recent years, many US exporters of both goods and services have consolidated their operations with those of European companies, helping them to surmount EU barriers. For example, US accounting firms typically operate through local partnerships. Other examples are management consulting firms with international operations that help address the needs of local clients and law firms with overseas offices.

Those MNEs that do choose to export to the EU must carefully select their agents and distributors. Five steps are critical to this process:

1 Examine the legal and business considerations involved in appointing foreign intermediaries and establish criteria that reflect the particular geographic market.
2 Assemble a list of potential candidates by using the various directories and consulting with other sources of information.
3 Qualify such candidates by applying certain criteria and conducting a preliminary interview.
4 Visit the proposed intermediary to obtain additional information about its resources and facilities, to get a proper feeling for the intermediary’s compatibility with the organisation, and to check the objectives of the agent or distributor.
5 After selecting an agent or distributor, (a) negotiate an agreement that is fair and mutually beneficial, (b) comply in good faith with the terms of the agreement, (c) continue communication between the parties, and (d) make occasional adjustments in the relationship in response to changing circumstances.

Table 16.4 Direction of EU trade

Rank	Total EU Trade with...	million euro	share (%)	EU Imports from...	million euro	share (%)	EU Exports to...	million euro	share (%)	EU trade balance with...	million euro
	Extra EU28	3,737,295	100.0	Extra EU28	1,858,783	100.0	Extra EU28	1,878,512	100.0	Extra EU28	19,729
1	USA	632,589	16.9	China	375,142	20.2	USA	375,826	20.0	USA	119,063
2	China	573,087	15.3	USA	256,763	13.8	China	197,944	10.5	Switzerland	39,990
3	Switzerland	260,842	7.0	Russia	145,003	7.8	Switzerland	150,416	8.0	United Arab Emirates	32,603
4	Russia	231,166	6.2	Switzerland	110,426	5.9	Russia	86,163	4.6	Hong Kong	25,780
5	Turkey	154,267	4.1	Norway	77,462	4.2	Turkey	84,492	4.5	Australia	21,676
6	Japan	129,568	3.5	Turkey	69,775	3.8	Japan	60,672	3.2	Stores and provisions – Extra EU	15,403
7	Norway	128,162	3.4	Japan	68,897	3.7	Norway	50,701	2.7	Turkey	14,717
8	South Korea	99,536	2.7	South Korea	50,025	2.7	South Korea	49,511	2.6	Mexico	14,068
9	India	85,937	2.3	India	44,215	2.4	United Arab Emirates	42,639	2.3	Singapore	13,106
10	Canada	69,213	1.9	Vietnam	37,016	2.0	India	41,722	2.2	Egypt	11,712
11	Brazil	63,394	1.7	Canada	31,474	1.7	Mexico	37,946	2.0	Saudi Arabia	11,207
12	Mexico	61,824	1.7	Brazil	31,170	1.7	Canada	37,739	2.0	Morocco	7,309
13	Saudi Arabia	54,964	1.5	Taiwan	29,529	1.6	Hong Kong	36,854	2.0	Lebanon	6,805
14	Singapore	53,250	1.4	Malaysia	25,033	1.3	Australia	34,688	1.8	Israel	6,541
15	United Arab Emirates	52,674	1.4	Mexico	23,878	1.3	Singapore	33,178	1.8	Canada	6,266
16	Taiwan	50,072	1.3	South Africa	22,706	1.2	Saudi Arabia	33,086	1.8	Oman	5,354
17	Hong Kong	47,928	1.3	Thailand	22,315	1.2	Brazil	32,224	1.7	Gibraltar	5,151
18	Australia	47,701	1.3	Saudi Arabia	21,878	1.2	South Africa	24,465	1.3	Qatar	3,903
19	Vietnam	47,640	1.3	Singapore	20,072	1.1	Morocco	22,427	1.2	Jordan	3,760
20	South Africa	47,171	1.3	Algeria	18,586	1.0	Israel	21,343	1.1	Ukraine	3,553

Many small and intermediate MNEs will continue to export to the EU because it is too expensive for them to use any other route. Large MNEs, on the other hand, are turning more and more to strategic acquisitions and alliances.

Strategic acquisitions and alliances

Two of the most popular ways of gaining a foothold in the EU are strategic acquisitions and alliances. A *Harvard Business Review* study analysed 49 strategic alliances and concluded that the chances of success are improved if the parties keep five guidelines in mind: (1) acquisitions work better than alliances when developing core businesses; (2) alliances are effective when firms want to gain entry into new geographic markets or businesses that are tangential to the core business; (3) alliances between strong and weak companies typically do not work well; (4) alliances that last are characterised by an ability to move beyond the initially established expectations and objectives; and (5) alliances are more likely to be successful when both sides hold an equal amount of financial ownership. In addition, more than three-quarters of the alliances studied ended with one of the parties acquiring full control.[2]

Making strategic alliances work

It is more common to find MNEs using strategic alliances than using acquisitions. One definition suggests that these are a cooperative arrangement between two or more companies in which:

- a common strategy is developed in unison and a win–win attitude is adopted by all parties;
- the relationship is reciprocal, with each partner prepared to share specific strengths with the other, thus lending power to the enterprise;
- a pooling of resources, investment and risks occurs for mutual gain.

Marketing considerations

The original vision for the EU was that it would progress towards a true economic and political union, with no internal barriers to the transfer of goods, services, people or capital. Some even saw a convergence of language and cultures, which has not taken place. The continued variation in cultures, languages, value and beliefs, alongside persistent differences in business institutions and regulations create challenges for EU firms expanding across the EU bloc and for foreign firms looking to enter any member country. As a result, marketing strategies have to consider pricing and positioning strategies for the overall EU bloc and for each country.

INTERNATIONAL BUSINESS STRATEGY IN ACTION

The future is Orange

Orange, formerly known as France Telecom until 2013, is a good example of an organisation that has grown stronger in its own home region, rather than aggressively expanding globally. The organisation has built up a major presence in the EU primarily through strategic alliances and through the acquisition of competitors. It can now use its strong EU home base as a staging ground to enter the North American and Asian markets, as was discussed in the earlier case on Vodafone (in Chapter 8).

Orange is a leading telecommunication operator in Europe. It offers services covering fixed and mobile communications, data transmission, the internet and multimedia, and other value-added services for individuals, businesses and other telecommunications operators. It operates in three segments: the Personal Communication Services (PCS); the Home Communication Services (HCS); and the Enterprise Communication Services (ECS). The PCS segment consists of the mobile telecommunication services in central and eastern Europe, Africa, the Middle East, the Caribbean and Asia; the HCS segment includes fixed-line telecommunication activities (fixed-line telephony, internet services and operator services), as well as the distribution and support functions provided to the other segments of the group; and the ECS segment provides communication solutions to large and small businesses worldwide.

The company operates a number of subsidiaries, and as of 2017 serves over 264 million customers, in 28 countries and 220 countries for Orange Business service. They operate in eight European countries, 70 per cent of revenues are generated in Europe, and 42 per cent from France (2018). With over $41.4 billion in revenues in 2018 and 156,000 employees (half outside France), the firm is one of Europe’s largest telecommunication companies.

Up to 1988, France Telecom (Orange) was a department in the French Ministry of Posts and Telecommunications. It began a process of privatisation in 1998, under Lionel Jospin’s government, but the French government still owns part of the firm. This causes periodic clashes with EU competition commissioners, including an allegation that the firm was paid the equivalent of over $1 billion in unlawful subsidies in 2004.

The rise of Orange in the European market and its expansion into wireless and internet are the result of a combination of R&D expenditures, alliances, and strategies. Orange has one of the largest research centres in Europe, employing over 8,000 people and holding over 6,498 patents worldwide. R&D efforts strive to facilitate human inter-action through telecommunications. Orange has also teamed up with other companies to complement its research efforts. In 2019, Orange and NTT Data Services signed a strategic R&D framework until 2022 to accelerate several key areas such as 5G, network transformation, Artificial Intelligence (AI), Internet of Things (IoT), cybersecurity, cloud services, smart cities, sports, tourism and culture. These types of partnerships are also used to improve the process through which services are provided.

R&D has helped Orange secure a place in the European market and reach out to new markets in the Asia Pacific and Africa. However, the fractured nature of the European market made strategic alliances a necessary element in Orange's international strategy. The EU's 28 members lack not only a common language but also a common regulatory system. Each country awards its own mobile licenses, forcing new entrants to make alliances with license holders. In addition, the previous fixed-line companies continue to own much of the local telecom infrastructure, increasing the benefits of partnering up.

Source: Ulrich Baumgarten/Getty Images

In 1995, Orange (France Telecom) joined Telekom and Sprint to form the Global One alliance, which was expected to serve as a springboard into the US market while protecting Orange's (France

Telecom's) home market from competition by Telekom. In 1999, Sprint was purchased by MCI World, effectively voiding the alliance. In the same year, Deutsche Telekom also rescinded its obligations when it sought a merger with Telecom Italia. As a result, Orange (France Telecom) redesigned its international strategy and began to compete directly with Deutsche Telekom in the German market by purchasing 17 per cent of E-plus, the country's third-largest cell phone operator. This marked a turning point for Orange's (France Telecom's) international strategy. The company now favours acquisitions over alliances.

In January 2000, France Telecom purchased the Global One alliance from its partners, an event that marked the beginning of a purchasing spree. Later that year, it bought Orange (UK) from Vodafone. Orange had a presence in 20 countries around the world, including 13 in Europe. France Telecom combined its own mobile business with that of Orange to create Europe's second-largest cell phone company. This acquisition was also a strategic move into the UK market. The firm's biggest competitor, Deutsche Telekom, had already purchased One2One in the UK. With 12.2 million active customers, Orange was the largest mobile operator in the UK, catapulting France Telecom into the big leagues. By 2000, Orange UK merged with T-mobile owned by Deutsche Telekom. This led to a rebranding strategy coming from a lack of dominant ownership by either the French or Germans; in 2012 as a compromise the companies launched a new network EE. Orange was phased out of the UK, however its brand value was such that France Telecom became Orange across the entire business in 2013.

Orange (France Telecom) also purchased Equant NV and Freeserve in 2000. Equant NV was combined with Global One under the name Equant. Like other telecommunications firms, Orange experienced a sharp decrease in share value in the early 2000s as a knock-on effect of the dot.com bust; the cost of buying 3G mobile licenses in the UK, Germany, France and Italy, among others; accumulated debt from the firm's acquisitions; and the lack of a strong market that would allow it to raise funds through the sale of equity. Despite this, and heavy competition from new entrants, France Telecom has been able to turn things around. Its share value has improved considerably and it remains a major European competitor. More recently its expansion has increased with purchases of One GmbH, the third-largest mobile operator in Austria, and 51 per cent of Telkom Kenya in 2007. In 2016, it expanded with the strategic acquisitions of Mobinil Egypt, Mobistar Belgium and Meditel

Morocco. In 2019, they laid a submarine cable to strengthen connectivity in French Guiana and the Antilles. This expands undersea cables to 210,929 km, enough to circumvent the Earth ten times.

Orange has come a long way from the days of the government-owned national carrier, France Telecom. In 1995, 75 per cent of its revenues were from fixed-line operations, and foreign sales accounted for only 2 per cent of revenues. As Figure 16.6 highlights, in 2018 France accounted for 42 per cent of revenues and most of this came from mobile and internet services. Revenue from Europe was 67 per cent of revenues and excluding France was 25 per cent, of which Spain accounted for 12.5 per cent. Worldwide markets including Africa and the Middle East accounted for 12 per cent, international carriers and shared services 4 per cent and enterprise 16 per cent. It is becoming more of a multinational, but remains highly dependent on the European market.

Websites: www.orange.com/en_EN/group/; www.francetelecom.com; www.sprint.com; www.equant.com; www.mci.com; www.one2one.co.uk; www.orange.co.uk; www.freeserve.com; www.wanadoo.fr; www.bt.com; https://www.theguardian.com/business/2014/apr/18/ee-phases-out-orange-mobile-brand-t-mobile-uk; https://www.orange.com/en/content/download/49464/1399807/version/2/file/2018%20Consolidated%20financial%20statements.pdf; https://www.orange.com/en/Press-Room/press-releases/press-releases-2019/Orange-and-NTT-sign-strategic-R-D-framework-agreement-to-accelerate-digital-and-network-transformation-in-5G-AI-IoT-cybersecurity-and-beyond; https://www.orange.com/en/Group/Orange-in-the-world; https://www.orange.com/sirius/histoire/en/history/

Sources: Adam Thomson, 'Network spending weighs on Orange as sales and revenues dip in Paris', *Financial Times*, 28 April 2015; 'T-Mobile and Orange in UK merger', BBC News, 8 September 2009; 'France Telecom: battling debt', BBC News, 19 April 2001; 'French giant targets alliance', BBC News, 12 October 1999; 'France Telecom clinches Orange deal', BBC News, 30 May 2000; 'France Telecom takes over Equant', BBC News, 20 November 2000; Richard Tomlinson, '5 moves to win the Telecom game', *Fortune*, 7 January 2002; France Telecom, Annual Report, 2010; Associated Press, 'France Tele-com shares decline as government moves to cut its stake', *International Herald Tribune*, 25 June 2007; Thomson Reuters, OneSource, 2011.

1. Describe the stages by which Orange (France Telecom) has built up a successful strategic base in the EU. What barriers to integration had to be overcome in the EU before France Telecom could buy up rival companies?
2. To what extent has the triad strategy of Orange/France Telecom been the same as that of Vodafone (in Chapter 8)? Are there any differences?
3. In what ways will integration and localisation be important issues for conducting mergers in the EU?
4. In what ways are both pricing and positioning important for companies like Orange doing business in the EU?

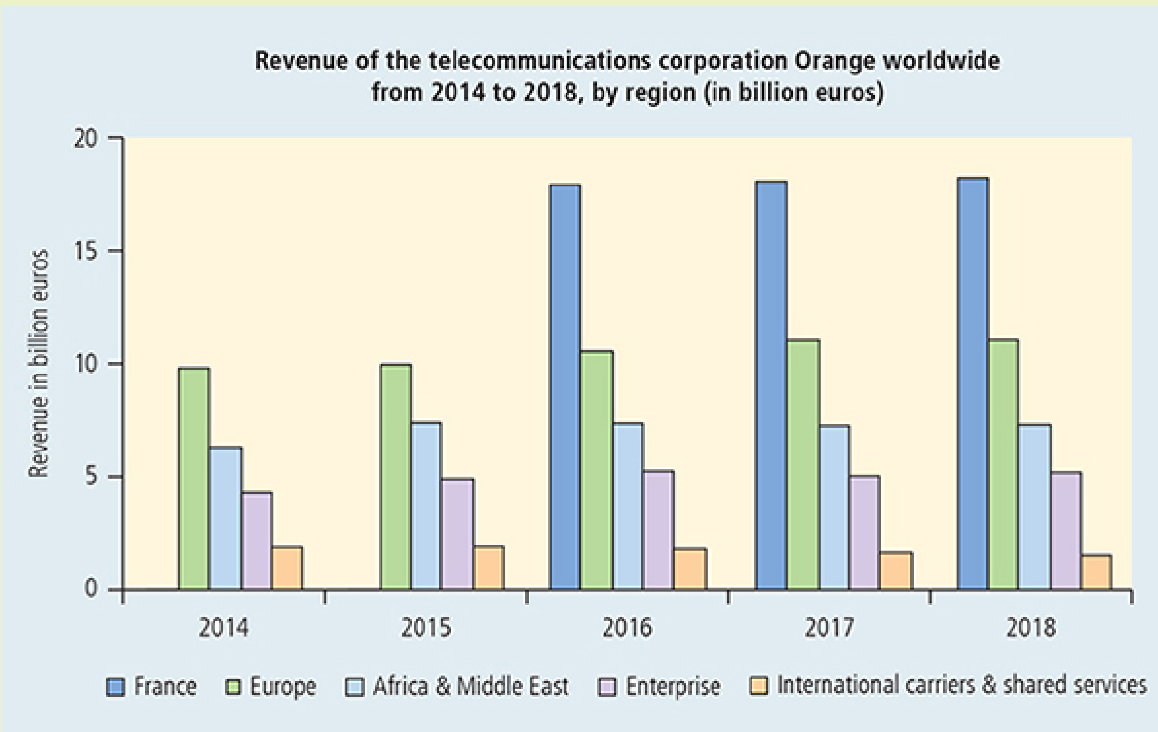

Figure 16.6 Orange consolidated financial statement (2014–18)

Pricing

The European Commission has estimated that the price of goods and services throughout the EU will decline. Five specific developments will make this

work: (1) decreasing costs of doing business, now that internal barriers and restrictions have been removed; (2) the opening up of public procurement contracts to broader competition; (3) foreign investment that will increase production capacity; (4) more rigorous enforcement of competition policy; and (5) general intensified competition brought about by economic reforms.

Price will become an even more important marketing factor to the extent that EU customers develop similar tastes and are willing to accept globally standardised products. As this happens, MNEs will be able to sell the same product throughout the bloc without having to make modifications for local tastes. Unfortunately, whereas some goods can be marketed with this strategy, many will require careful positioning for select target groups.[3]

Positioning

Some global products, such as Coca-Cola, Ed Sheeran songs and iPhones, have universal appeal, but these are more the exception than the rule. For example, in the UK Renault cars are viewed as good economy cars, but in Spain they are perceived as luxury automobiles. Similarly, in the UK and the Netherlands, toothpaste is viewed as a hygiene product and sells much better than in Spain and Greece, where it is marketed as a cosmetic.

As a result, the marketing motto 'Plan globally, act locally' will continue to be a useful dictum. A good example is provided by the EU cellular communications market, which offers tremendous opportunities but is also extremely competitive because there are so many submarkets throughout the community. As a result, the mobile communications market will likely end up being divided among a host of major competitors, each of which will position itself for a particular local or regional target group.

Social media

Between 2013 and 2017, the number of EU enterprises using social media for marketing purposes increased from 22 to 40 per cent. It also grew from 15 to 27 per cent as a means of communicating with customers and from 9 to 23 per cent as a way of recruiting employees.[4] This includes social networks, blogs, multimedia content-sharing sites, tweets and wikis as well as LinkedIn, Instagram and Snapchat. Firms use social media for both marketing (image-building) and market research (gaining a better understanding of customers). But it is also used for communicating internally and with external partners.

One study proposes that the overall convergence associated with European market integration will lead firms to emphasise three advertising strategies: creating a uniform brand image; appealing to cross-market segments; and increasing cost performance in advertising.[5] The success of this strategy is, however, dependent on the degree to which convergence – in cultural values, beliefs, tastes, does take place. There are growing signs of divergence and localisation across some of these dimensions in the EU.

Producing products and services in the EU

The degree to which standardised rules and regulations evolve across the EU is also a key factor for firms wanting to produce services and products inside the region. A wide range of national infrastructural and regulatory differences, from power systems and plug sockets to tax laws and health and safety regulations, reduce the economies of scale and increase the complexity for foreign firms entering the market. The current situation drives firms to 'modularise' parts of products (and use 'delayed differentiation' – see below) and segment services to enable some degree of standardisation, with minimal customisation to suit local requirements.

To realise economies of scale, maintain quality at low cost and support adaptation to local conditions, firms often look to partnerships and alliances with local firms.

Reducing costs

There are now over 500 million consumers in Europe and their expenditure represents over half of the EU's GDP. One manufacturing benefit of producing for this size of market is the ability to reduce cost per unit through the use of standardised components and large production runs. Economies of scale are possible, with the cost of components kept to a minimum and large production runs allowing companies to spread fixed costs over more units. This means the cost per item can be sharply reduced. Moreover, economies of scale can be achieved even when production has to be tailored to local conditions. This is accomplished through the use of **delayed differentiation**, in which all products are manufactured in the same way for all countries or regions as late as possible in the assembly process. In these final stages, differentiation is then used to introduce particular features or special components.

MNEs also use outsourcing and just-in-time inventory systems to lower the cost of carrying parts and supplies. By tailoring deliveries and shipments to the production schedule, factories are able to minimise their investment in materials and work-in-process. This system is also used by large retailers such as Marks & Spencer in the UK, which employs its electronic network system to keep track of inventory at each store in England, as well as on the continent, and to replenish its outlets as needed.

Another way in which costs are being controlled is by redesigning production processes, thus scrapping old, inefficient techniques in favour of more streamlined methods. This includes careful study of competitive firms in order to identify and copy their successful approaches to cost control. It also entails the elimination of red tape and the use of well-trained, highly motivated work teams.

Factory networks

Mainland Europe benefits from having a dense and efficient transport infrastructure. This has helped MNEs to develop sophisticated networks of factories that both produce components and finished goods and provide distribution and after-sales services. For example, the Philips television factory in Bruges, Belgium, uses tubes that are supplied from a factory in Germany, transistors from France, plastics produced in Italy and electronic components that come from another factory in Belgium.

These factory networks are also integrated with computer software packages that can operate in multiple European countries without the need for modification. The software packages allow companies to make supply, production and distribution decisions while satisfying the requirements of the different legal entities in the countries where they operate. Some specific functions they help companies to perform include forecasting, logistics planning, inventory planning, production planning and central updating of bills of materials. The software provides each factory manager with the specific information needed and does so in the manager's own language. As a result, MNEs are able to coordinate multiple activities and thereby develop an effective pan-European manufacturing system.

✔ Active learning check

Review your answer to Active Learning Case question 4 and make any changes you like. Then compare your answer to the one below.

4 Discuss whether JLR are likely to re-shore or offshore production after the UK leaves the EU.

If JLR re-shored its operations to the UK this would help to overcome issues concerning the rise in labour costs in emerging economics, transportation costs, ease of market access and concerns over quality levels. However, after the UK leaves the EU, JLR would still be subject to tariffs on exported vehicles. Considering that the cost of producing 50,000 components in the UK would exceed the costs of producing 1 million equivalent components in Poland, and given that the majority of JLR's sales are in the EU, it is more likely that they will offshore production. Moreover, given the advantages (efficient transport infrastructure, factory networks, R&D clusters) of mainland Europe, it is expected that JLR's production will be offshored to Europe.

R&D alliances

Another emerging manufacturing strategy is participation in cooperative R&D programmes. In the EU this is taking two complementary paths. First, many companies are teaming up to share R&D expenses. Siemens and Philips have used this approach to develop computer chips and IBM has a number of agreements with European firms for developing advanced computer technology.

Second, many firms are trying to get some of these costs funded by participating in European cooperative R&D programmes. The EU provides European industry with funding for research in such areas as information technology, biotechnology and energy. The objective of the programme is to stimulate cross-border cooperation and make Europe more productive and

competitive in the world market. One of the best-known programmes is the **European Research Cooperation Agency** (Eureka, for short), which was launched in 1985 and emphasises projects in the fields of energy, medicine, biotechnology, communications, information technology, transport, new materials, robotics, production automation, lasers and the environment.[6] This program has helped develop a European standard for high-definition television (HDTV) and has funded semiconductor research. A central aim is to meet the European objective of raising investment in R&D. EU funding for large-scale projects and coordination across member states also drives economies of scale in R&D, to allow countries to compete in science and technology development with the USA, Japan and China. Firms that are interested in participating in these cooperative programmes typically do so by carrying out six steps:

1. Find out if the company is eligible for EU-funded programmes.
2. Carefully study the EU rules regarding rights of ownership and dissemination of results.
3. Carefully choose the best location for a European R&D centre.
4. Determine those competitors and major customers that are already participating in the programme.
5. Gather recommendations from the firm's EU and local management.
6. Put together the company's application for funding.

Management considerations

As more firms enter the EU, there is growing concern over their ability to manage Europeans effectively. Many firms enter the market with preconceived ideas about how to interact with their European partners or employees. Some, for example, believe that management styles that have been effective in their country will also work well in Europe. However, as the Japanese have discovered in the United States, effective management

approaches must be tailor-made to meet the needs of the local situation. The primary focus must be on adjusting to cultural differences.

Adjusting to cultural differences

While there are many cultural differences between EU countries, there are also many differences when we compare the Europeans with other cultures. Chapter 5 on 'International Culture' explores these differences in some detail. In general, for example, Europeans are more accustomed to participating in decision making. They have a long history of worker participation programmes and of holding seats on the board of directors. They are also motivated or incentivised differently than employee groups from other countries. Quality of work life is extremely important, particularly in Scandinavian countries, whereas opportunities for individual achievement are of particular importance in the UK. French workers are interested in individual achievement but place strong emphasis on security. German workers place a high value on both advancement and earnings. Clearly, no universal list of motivators can be applied throughout the EU. These facts illustrate the importance of MNEs having a global perspective as well as having managers who are focused on the country-specific needs of the area in which they are working.

Barriers to EU market access

Throughout this book, we have explored the need for access to triad markets. Although the EU has become the world's largest market, some EU-based MNEs and governments have sought to restrict access to this area. The overall trend during the post-war period has been towards an increasingly liberalised trade environment, but this has recently changed, with trade disputes between the US and China at centre-stage (See Chapter 6 on 'International Trade') and the EU also setting up some new barriers. International managers must know

how to anticipate and deal with both tariff and non-tariff administrative barriers in foreign markets.

The two most common trade law entry barriers are **countervailing duty (CVD)** laws and **anti-dumping duty (AD)** laws (discussed earlier in Chapter 6). While the United States tends to use CVDs as an entry barrier, the EU tends to use ADs. Both CVD and AD laws are import tariffs intended to protect domestic producers from harmful dumping and subsidisation by foreign governments. However, it has been demonstrated in several studies that these laws have been 'captured' and used by weak firms seeking shelter from strong competition by rival MNEs in the triad.

Table 16.5 shows both the high number of AD cases that were launched and the tendency towards sectoral concentration in the use of AD by EU firms during the period from 2009 to 2017. Many AD cases were brought in the chemical, electronics, iron and steel, and other 'mature' sectors that have weak firm-specific advantages (FSAs).

Figure 16.7 shows the rationale for the use of AD and CVD laws by particular firms. As with all free market economies, the EU economy has, at any given point in time, a significant number of firms in difficulty due to the pressure of global competition. These firms are barely able to compete with their more efficient global rivals and find themselves on the verge of exit from the industry. If the main reason for this is international competition, and domestic administrative instruments are in place that would allow such a firm to continue operating by limiting foreign competition, the company is likely to use these instruments. Such a situation is a rare instance when it is logical for a firm to spend time and money on an activity that is not productive from a competitiveness standpoint. By using AD or CVD laws, the uncompetitive firm is able to remain in operation not by improving its firm-specific advantages, but by artificially raising the price at which foreign competitors must sell in the domestic market.

Table 16.5 EU anti-dumping cases investigated by sector, 2009–17

	2009	2010	2011	2012	2013	2014	2015	2016	2017
Chemical and allied	9	7	11	0	1	2	6	1	5
Textiles and allied	3	0	0	0	3	0	0	0	0
Wood and paper	0	2	0	0	0	0	0	1	0
Electronics	1	2	0	2	0	0	0	0	0
Other mechanical engineering	1	1	1	1	0	0	0	0	1
Iron and steel	4	3	6	11	1	9	6	13	0
Others, metal	1	0	1	0	0	3	0	0	2
Other	2	3	2	5	4	2	2	0	3
All products listed	**21**	**18**	**21**	**19**	**9**	**16**	**14**	**15**	**11**
of which anti-dumping	15	15	17	13	4	14	12	14	9
of which anti-subsidy	6	3	4	6	5	2	2	1	2

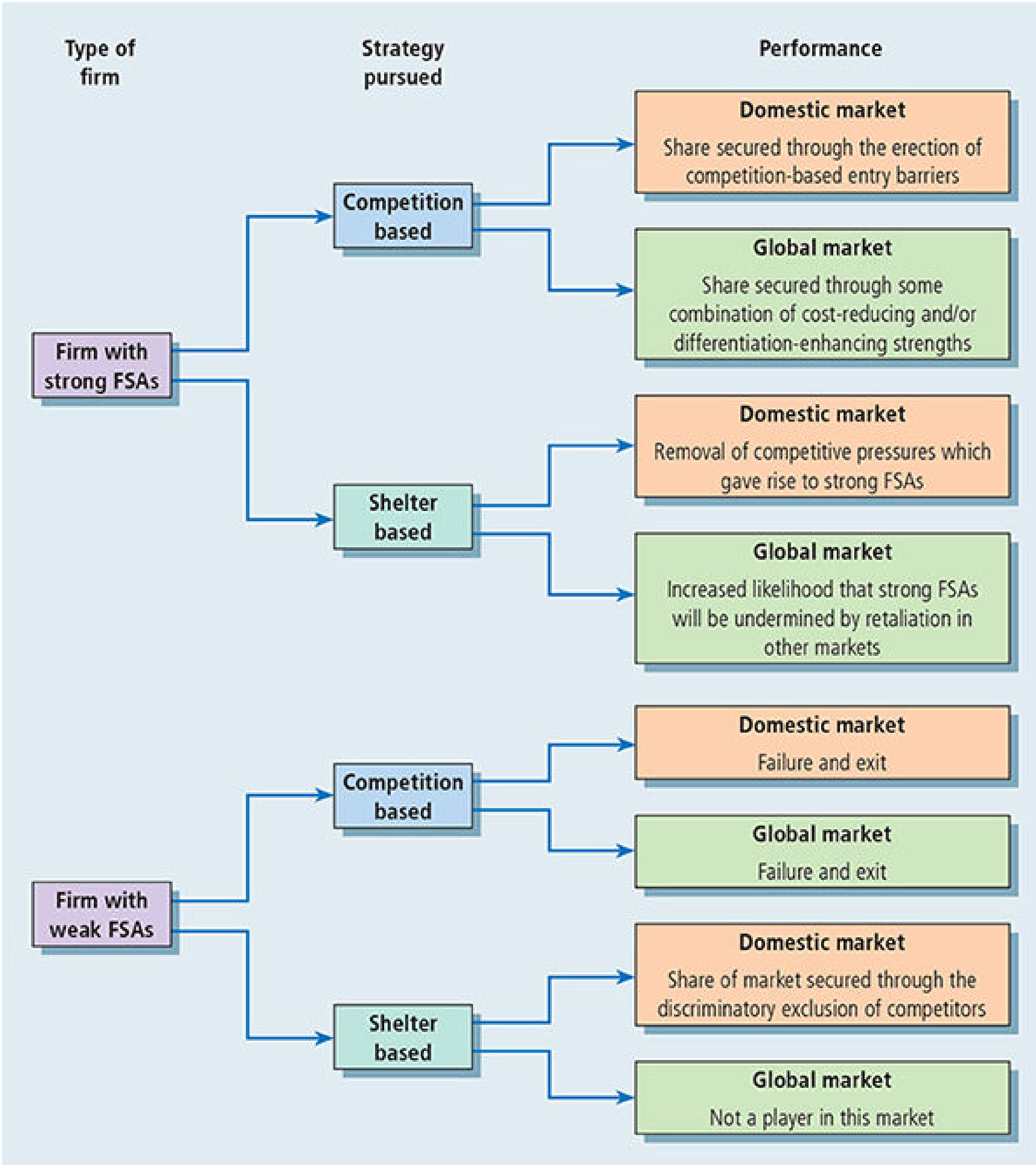

Figure 16.7 Competition and shelter-based strategies

The abusive use of AD and CVD is a particular problem for non-triad members and for MNEs from other parts of the triad because the administration of these trade laws is discretionary and subject to political pressures. Moreover, there is now strong evidence that the administration of these trade laws is biased in favour of domestic plaintiffs and against foreign

firms.[7] The technical test of 'material injury' due to the subsidies or dumped exports is routinely abused by the responsible administrative agencies in both the EU and the United States. This is an extremely serious problem for global business and serves to reinforce the existence of the triad at the expense of a liberalised world trade and investment system.

KEY POINTS

1. The overall objective of the EU is to create a market in which there are no economic barriers to trade between the member countries. If this were to be achieved, the EU will be the largest economic bloc in the world. Free movement of people and goods is proving challenging, particularly given Brexit. Complete financial unification, with all members adopting the Euro, might be more likely with the exit of the UK and other members.
2. The current competitive status of the EU lags that of the United States but exceeds that of Japan in terms of productivity. Increased investment spending, improved education systems and a focus on collaborative R&D are targets to improve both competitiveness and inclusivity.
3. In preparing to do business in the EU, MNEs should focus on the competitive nature of the targeted industry and the evaluation of location. Competitive intelligence gathering and location evaluation entails the consideration of such factors as regional incentives, operating costs and distance from major markets.
4. Many aspects of strategy need to be considered when doing business in the EU, including (a) an overall analysis of the environment, (b) the feasibility of exporting, (c) the value of strategic alliances and acquisitions, (d) marketing considerations, (e) manufacturing approaches, and (f) management considerations. Managers need to weigh the choices of economic integration and/or national responsiveness very carefully.
5. The EU has a large internal market. Firms located in the EU can use non-tariff barriers to entry to keep out rival firms: namely, trade remedy

legislation such as countervailing duty (CVD) laws and anti-dumping (AD) laws.

Key terms

- **Council of Ministers**
- **Single European Market (SEM)**
- **productivity**
- **delayed differentiation**
- **European Research Cooperation Agency**
- **countervailing duty (CVD)**
- **anti-dumping duty (AD)**

REVIEW AND DISCUSSION QUESTIONS

1 What are the ultimate objectives of the EU? Identify and describe them.
2 What is the Single European Market and how does it benefit EU firms?
3 What is the competitive status of the main EU economies in terms of labour productivity and investment spending? Based on your answer, what is your overall evaluation of this status?
4 How can firms doing business in the EU use competitive intelligence? Identify and describe two major steps that can be used in this process.
5 What types of regional incentives do countries offer MNEs willing to set up operations in their locales? Identify and describe two of them.
6 In addition to regional incentives, what other evaluation criteria should MNEs employ when deciding where in the EU to establish operations? Identify and describe three of them.
7 In formulating a strategy for doing business in the EU, there are two primary areas of initial consideration: national responsiveness and economic integration. What does this statement mean?
8 What do companies that want to export to the EU need to know about doing business there? Discuss five facts or strategies that would be of value to them.
9 In gaining a foothold in the EU, when is it most effective to opt for an acquisition over an alliance? When is a strategic alliance a better choice? In each case, provide an example.
10 Why will marketing strategies in the EU have to reflect a concern for pricing? A concern for positioning? Give an example of when each would be the most important consideration.
11 What is the likely future of direct marketing in the EU? Defend your answer.
12 What are three major manufacturing considerations for companies doing business in the EU? Identify and describe each.
13 How important is it for EU managers to have a global perspective?
14 How can trade laws be used by EU firms to keep out global competitors?
15 What evidence is there that EU firms use anti-dumping laws?

16 The EU has accepted a number of new members into the union over the course of its development. Are these members fully integrated? What problems might we envisage from new members in the future?

17 How are new entrants into the union likely to affect employment in the EU?

REAL CASE

Accor budget hotels

The largest manager of budget-priced hotels in the world is the French company Accor. In 2014 it owned over 3,717 hotels in 90 countries under the brands Sofitel, Pullman, Novotel, Mercure, Suitehotel, All Seasons, Ibis, Etap Hotel, Formule 1 and Motel 6, and its related activities, Thalassa Sea & Spa and Lenôtre, with a portfolio ranging from luxury to budget class. With a workforce of 250,000 employees, Accor generated revenues of just over $2 billion in 2017. A total of 25 per cent of its hotel rooms were located in France and Switzerland, 27 per cent in the rest of Europe, 27 per cent in Asia-Pacific and 21 per cent in the rest of world. Accor is a home-region firm with focus on Europe, where 54 per cent of its hotel rooms are located.

The Accor Group has developed international capabilities, however, as a major service provider to the tourist, business travel and food business sectors. It is developing an international brand name for the Group's activities in these areas and uses B2B and B2C internet services extensively for the purposes of promotion and managing partnerships. There are 860,000 restaurant managers, supermarket suppliers and other affiliated workers using its B2B services, along with another 300,000 customers/small-business people using B2C.

The company began operations in 1967 and rapidly expanded its Novotel hotels across France. The acquisition of another hotel chain in 1974, Courtepaille, established Accor as a major player in the French market. During the next two years the company moved to develop a market presence in the two- and three-star hotel market segment, opening an Ibis two-star hotel in Bordeaux and acquiring the three-star Mercure hotel chain.

The first significant expansion outside France was the 1973 opening of Novotel in Warsaw, Poland. In 1976, Accor opened its first hotel in Brazil and over the next year it began to rapidly develop in Latin America. In 1979, Accor entered the US market with hotels in Minneapolis and New York; in 1984 a large Novotel was erected in Broadway. To enter the affordable US hotel market, the Motel 6 chain was purchased in 1990. By acquiring Sofitel in 1980 the company entered the African market and strengthened its position in Europe. In 1986, Accor began development in

Asia, including China and Thailand. In preparation for the 2008 Olympic Games, Accor entered a joint venture with the Beijing Tourism Group to manage 50 hotels.

Table 16.6 Accor Hotel portfolio by region, 2018

	Franchised	Franchised	Managed	Managed	Hotel Assets (owned/leased)	Hotel Assets (owned/leased)	Total	Total
	Hotels	Rooms	Hotels	Rooms	Hotels	Hotels	Hotels	Rooms
Europe	1,728	155,540	1,030	148,048	121	21,882	2,879	325,470
Asia-Pacific	290	40,740	677	149,266	39	6,624	1,006	196,630
Middle East & Africa	21	3,905	192	42,223	9	1,586	222	47,714
North America, Cent	12	2,659	74	27,472	0	0	86	30,131
South America	104	12,986	173	28,210	60	11,798	337	52,994
Total	**2,155**	**215,830**	**2,146**	**395,2**	**229**	**41,890**	**4,530**	**652,939**
Total as a %	**47.6%**	**33.1%**	**47.4%**	**60.5%**	**5.1%**	**6.4%**	**100.0%**	**100.0%**

Accor is also in the travel business. In France it owns Carlson Wagonlit Travel and Frantour. Acquiring international travel companies has allowed Accor to complement its international hotel expansion plans. The acquisition of Africatours in 1984 allowed Accor to control the stream of tourism in the region. In 1987, Africatours acquired Asia Tours and America Tours. In 2000, Accor purchased a 38.5 per cent stake in Go Voyages, an e-travel planner that targets the European traveller. Growing expertise in the hospitality business has also allowed the company to diversify into other areas, including restaurants and casinos. Table 16.6 shows the global spread of Accor hotels by region and brand.

A report by Datamonitor outlined the Accor Group's main strengths and weakness in 2008. Strengths include: a wide range of product and service offerings, an improving financial position and a strong focus on customer service. Weaknesses include: underperforming assets, an overdependence on hotels (65 per cent of revenues) and a geographic concentration in Europe (75 per cent of revenues). The recovering European hotel industry, current expansion in China and India, and the recovering business travel market are all opportunities for the Group. These are offset by the growing range of competitors, particularly in the low-cost travel and leisure segments.

Websites: www.accorhotels.com; www.accor.com; www.fourseasons.com; www.sixcontinents.com

Sources: www.accorhotels.com; Raphael Minder, 'Accor may have to rethink casino offer', *Financial Times*, 3 January 2002; Raphael Minder, 'Accor to acquire casino group for E258m',

Financial Times, 17 December 2001; ‘Casinos on threshold of recomposition’, *La Tribune*, 3 January 2002; ‘Accor agrees Chinese JV to manage around 50 hotels by 2008’, *AFX Europe*, 12 December 2001; Anaïs Jouvancy, ‘European E-travel takes off’, *Le Monde Interactif*, 8 November 2000; Accor SA, *Annual Report*, 2010, 2014, 2017; Thomson Reuters, *OneSource*, 2011; www.datamonitor.com.

1 Why did Accor concentrate on the French and European markets before expanding into other regions?

2 How are acquisitions an important part of Accor’s expansion strategy?

3 What are the advantages of increasingly relying on the internet for B2B and B2C?

REAL CASE

Carrefour

French retail giant Carrefour (‘crossroads’ in French) is the number one retailer in Europe and number two in the world. In 2018, Carrefour made approximately 74 per cent of its sales in Europe, but it had 12,300 stores spread throughout 33 countries on four continents, with revenues of $76 billion and a workforce of 380,000 employees. In 2018, Carrefour SA’s total revenue decreased by 2.7 per cent in comparison to 2017.

Saturated domestic markets, economic growth in Asia and eastern Europe, and improvements in transportation systems are all factors driving large retailers to expand abroad, with mixed success. Tesco has moved into China and the United States, Carrefour has pulled out of some eastern European countries in order to focus on expansion in China and Wal-Mart is pushing for growth in a range of new markets.

Carrefour SA is a France-based company that is primarily engaged in retail distribution. It operates a network of hypermarkets, supermarkets, hard discount stores, convenience stores and cash-and-carry outlets, and offers e-commerce services. The company’s hypermarkets, Carrefour and Atacadão, offer a range of food and non-food products. Carrefour SA’s supermarket chains include, among others, Champion and Norte brands, which primarily offer food, clothing and household goods. The company’s hard discount stores include Dia, Ed and Minipreço, offering products at discount prices. Its convenience stores, such as Shopi and 8 à Huit, offer a range of convenience products and services. Carrefour SA’s cash-and-carry stores, Promocash, Gross and Docks Market, offer wholesale products for businesses. As of 31 December 2014, the company was 8.11 per cent owned by Blue Partners.

Anyone observing Carrefour over the last three decades must concede that international expansion is a key part of its strategic plan. Despite this, in 2008, 47 per cent of its sales were in France alone and 81 per cent in Europe. The 19 per cent of sales outside the region were evenly divided across Asia and Latin America. By 2014, 35 per cent of its sales were in France and 55 per cent in Europe, 14 per cent in Latin America, and 6 per cent in Asia. By 2018, 47 per cent of its sales

were in France. Carrefour is under pressure in its home market of France as rivals keep prices low to gain market share.

In 1996, the French government introduced the ‘Raffarin law’ to restrict the expansion of hypermarkets, with the aim of keeping the French countryside from turning into large warehouse-style retail structures. This in turn would protect the French way of life, in which local food farmers supply small local shops. For Carrefour, this meant that growth of its hypermarket business could come only from acquisitions in its local market or from expanding into foreign markets. Its success at following this strategy has varied considerably because of different competitive environments and cultural differences across regions.

In the United States, Carrefour opened three hypermarkets in Pennsylvania and closed them as a result of local competition. In its home region of Europe, however, Carrefour is the number one retailer in Spain, Portugal and Greece, and the second largest in Italy.

Source: Craig Joiner Photography/Alamy Stock Photo

Carrefour was the first Western hypermarket company to expand into the Asian market in the mid-1990s. By 2001 it was the third largest retailer in China and had operations in Thailand and Japan. The company gambled that Asian customers would be willing to move from their traditional outdoor markets to purchase at air-conditioned and ‘all under one roof’ hypermarkets. These hypermarkets rely on local suppliers that can offer products at the same price level as those supplied to the local competition and cater to the tastes of locals. For their part, local suppliers are all too

ready to enter contracts with Carrefour, which promises to put their products on shelves across the Asian region. Moreover, where local contacts are not readily available or insufficient, Carrefour's competitive advantage comes from its economies of scale, centralised purchasing and power over the supply chain, plus operations and logistics efficiencies.

Because products are offered in a comfortable environment at competitive prices, the local competition is nothing to worry about. In fact, Carrefour is more concerned about competition from other Western retailers such as Walmart and Tesco. Tesco and Carrefour raced to open the first hypermarket in the Thai market and basically tied. Both their hypermarkets faced each other in a busy Bangkok street. If they want to survive in the long haul, however, Western companies should always be wary of potential local or regional competitors. In Hong Kong, where Jardine Matheson and Li Ka-shing dominate the market, Carrefour was forced to close operations. The group now sees strong potential for further international growth in the large national markets of China, Brazil, Indonesia, Poland and Turkey.

But the benefits of international expansion are not completely clear. Carrefour and other large retailers have tended to enjoy higher operating margins in their domestic markets. They have also struggled to leverage scale economies on a global basis because, in order to cater to local tastes, hypermarkets must purchase from local producers. Indeed, in November 2010, Carrefour announced the signing of an agreement with Big C, a subsidiary of Groupe Casino (France), for the divestment of its operations in Thailand for an enterprise value of Ä868 million. Carrefour plans to sell 19 stores in Malaysia and two in Singapore; it shut down its Xi'an outlet in China's Shaanxi Province in July 2010.

On the other hand, Carrefour SA announced the opening of its first Cash & Carry Store in India in December 2010. With a sales area of 5,200 m^2, this store, located east of New Delhi in the Shahdara neighbourhood, will offer more than 10,000 stock-keeping units in food and non-food to professional businesses, institutions, restaurants and local retailers. Carrefour had opened three supermarkets by the end of 2010 and two hypermarkets in 2011 in Romania. The supermarkets were opened in the capital, Bucharest, in the southern town of Târgovişte, and in the northwestern town of Cluj. The hypermarkets slated for a 2011 launch were located in Bucharest and in the northern town of Botoşani.

Since 2011, shares in Carrefour have gradually been falling since Europe's biggest retailer issued a warning that profits in its core French market were set to fall, as it is facing fierce competition from rivals in France.

Sources: www.carrefour.com; 'Wal-Mart, Tesco and Carrefour do battle in the East: international retailers find mixed fortunes in their expansion strategies', *Strategic Direction*, vol. 24, no. 2 (2008), pp. 5–7; Peter Child, 'Lessons from a global retailer: an interview with the President of Carrefour China', *McKinsey Quarterly*, special edition, 2006, pp. 70–81; Carrefour, *Annual Report*, 2008–18; 'French fusion', *The Economist*, 2 September 1999; 'A hypermarket', *The Economist*, 5 April 2001; Thomson Reuters, *OneSource*, 2011; 'Carrefour shares fall after profit warning', *BBC News*, 17 June 2011.

1 How can Carrefour compete with local retailers in North America?

2 How can Carrefour compete with local retailers in Asia?

3 What strategy does Carrefour need to succeed in Europe?

4 What is Carrefour's basic strategy and structure?

5 Should Carrefour and other large retailers even attempt to expand internationally?

NOTES

1 https://europa.eu/european-union/about-eu/figures/living_en

2 https://hbr.org/2018/05/why-traditional-ma-is-becoming-less-important; Joel Bleeke and David Ernst, 'The way to win in cross-border alliances', *Harvard Business Review*, vol. 69, no. 6 (1991), pp. 127–8. See also: *Harvard Business Review on Strategic Alliances* (Cambridge, MA: Harvard Business School Press, 2013).

3 Hooley, Graham, Saunders, John, Piercy, Nigel F. and Nicoulaud, Brigitte, *Marketing Strategy and Competitive Positioning*, 6th ed. (Harlow: Pearson, 2017).

4 https://ec.europa.eu/eurostat/statistics-explained/index.php/Social_media_-_statistics_on_the_use_by_enterprises

5 Shintaro Okazaki, Charles R. Taylor and Jonathan P. Doh, 'Market convergence and advertising standardization in the European Union', *Journal of World Business*, vol. 42, no. 4 (2007), pp. 384–400.

6 See http://www.eurekanetwork.org

7 For an overall discussion of triad power and the use of trade laws as barriers to entry, see Francis G. Snyder, *Regional and Global Regulation of International Trade* (London: Hart Publishing, 2002); David Coen, Wyn Grant and Graham Wilson, *The Oxford Handbook of Business and Government*, Oxford Handbooks in Business and Management (Oxford: Oxford University Press, 2010). Also: Chris Turner and Jacqueline Martin, *Key Facts EU Law*, 3rd ed. (London: Hodder Education, 2011).

BIBLIOGRAPHY

Apergis, Nicholas, Fafaliou, Irene and Polemis, Michael L. 'New evidence on assessing the level of competition in the European Union banking sector: A panel data approach', *International Business Review*, vol. 25, no. 1 (2016).

Archibugi, Daniele and Filippetti, Andrea. *Innovation and Economic Crisis: Lessons and Prospects from the Economic Downturn*, Routledge Studies in Global Competition (London: Routledge, 2011).

Asmussen, Christian Geisler, Pedersen, Torben and Dhanaraj, Charles. 'Host-country environment and subsidiary competence: extending the Diamond Network Model', *Journal of International Business Studies*, vol. 40, no. 1 (2009).

Blevins, Dane P. et al. 'Institutional changes within the European Union: how global cities and regional integration affect MNE entry decisions', *Journal of World Business*, vol. 51, no. 2 (2016).

Böhm, Hans and Scholz, Christian. *Human Resource Management in Europe: Comparative Analysis and Contextual Understanding* (London: Taylor and Francis, 2008).

Brennan, Louis. *The Emergence of Southern Multinationals: Their Impact on Europe* (Basingstoke: Palgrave Macmillan, 2010).

Brenner, Steffen. 'Self-disclosure at international cartels', *Journal of International Business Studies*, vol. 42, no. 2, (2011).

Chen, Wen, Los, Bart, McCann, Philip, Ortega-Argilés, Raquel, Thissen, Mark and van Oort, Frank. 'The continental divide? Economic exposure to Brexit in regions and countries on both sides of The Channel', *Papers in Regional Science*, vol. 97, no. 1 (2018).

Colantone, Italo and Sleuwaegen, Leo. ‘International trade, exit and entry: a cross-country and industry analysis’, *Journal of International Business Studies*, vol. 41, no. 7 (2010).

Cumming, Douglas J. and Zahra, Shaker A. ‘International business and entrepreneurship implications of Brexit’, *British Journal of Management*, vol. 27, no. 4 (2016).

Curran, Louise and Zignago, Soledad. ‘EU enlargement and the evolution of European production networks’, *Research in International Business and Finance*, vol. 26, no. 2 (2012).

Dhingra, Swati, Huang, Hanwei, Ottaviano, Gianmarco, Pessoa, João Paulo, Sampson, Thomas and Van Reenen, John. ‘The costs and benefits of leaving the EU: trade effects’, *Economic Policy*, vol. 32, no. 92 (2017).

Duarte Alonso, Abel and Kok, Seng. ‘Dynamic capabilities in the context of Brexit and international wine business: An exploratory two-country study’, *Thunderbird International Business Review*, vol. 61, no. 2 (2019).

Dunning, John H. ‘Review of *European Union and the Race for Foreign Direct Investment in Europe*’, *Journal of International Business Studies*, vol. 37, (2006).

Filatotchev, Igor and Piesse, Jenifer. ‘R&D, internationalization and growth of newly listed firms: European evidence’, *Journal of International Business Studies*, vol. 40, no. 8 (2009).

Greenaway, David. *The World Economy: Global Trade Policy*, World Economy Special Issues (Oxford: Wiley-Blackwell, 2010).

Guerrieri, Paolo and Caffarelli, Filippo Vergara. ‘Trade openness and international fragmentation of production in the European Union: the new divide?’ *Review of International Economics*, vol. 20, no. 3 (2012).

Ott, Ursula F. and Ghauri, Pervez N. ‘Brexit negotiations: From negotiation space to agreement zones’, *Journal of International Business Studies*, vol. 50, no. 1 (2019).

Suder, Gabrielle. *Doing Business in Europe*, 3rd edn (London: Sage Publications, 2018).

Radosevic, Slavo and Kaderabkova, Anna. *Challenges for European Innovation Policy: Cohesion and Excellence from a Schumpeterian Perspective* (Cheltenham: Edward Elgar, 2011).

Reynaud, Emmanuelle, et al. ‘The differences in values between managers of the European founding countries, the new members and the applicant countries: societal orientation or financial orientation?’ *European Management Journal*, vol. 25, no. 2 (April 2007).

Rugman, Alan M. and Collinson, Simon. ‘Multinational enterprises in the new Europe: are they really global?’ *Organizational Dynamics*, vol. 34, no. 3 (2005).

Rugman, Alan M. and Oh, Chang Hoon. ‘Regional integration and the international strategies of large European firms’, *International Business Review*, vol. 20 (2011).

Rugman, Alan M., Yip, George and Kudina, Alina. ‘The international success of British companies’, *Long Range Planning*, vol. 39, vol. 3 (June 2006).

Schmitt, Alexander and Van Biesebroeck, Johannes. ‘Proximity strategies in outsourcing relations: the role of geographical, cultural and relational proximity in the European automotive industry’, *Journal of International Business Studies*, vol. 44, no. 5 (2013).

Ueltschy, Linda C., Laroche, Michel, Rita, Paulo and Bocaranda, Claudia. ‘A pan-European approach to customer satisfaction: an optimal strategy?’ *Multinational Business Review*, vol. 16, no. 3 (2008), pp. 41–71.

Chapter 17

JAPAN

Contents

Objectives of the chapter

Japan is arguably the odd one out of the three triad regions of the world. Political, social, cultural and economic differences underpin its unique business infrastructure and the strengths and weaknesses of its firms, relative to competitors from elsewhere. Historically it has undergone a period of unprecedented growth and internationalisation and more recently recession, and this process of change helps explain this uniqueness. To understand what is so unusual about the current period for Japan, and why the ongoing corporate restructuring is so fundamental, we need to understand something of this past.

This chapter has a number of aims. By providing an overview of the key economic, political, social and cultural characteristics of Japan, we can understand more about the Japanese market and the opportunities and constraints it represents for foreign firms. We can also understand more about Japanese corporations: how and why are they different and what are the implications for collaborators and competitors?

Such insights are important for firms defending their own domestic markets against Japanese MNEs, for foreign firms breaking into the Japanese market, and for MNEs acquiring or partnering Japanese firms or recruiting Japanese employees. At a broader level, by making the links between national characteristics and corporate behaviour explicit, we can improve our understanding of the sources of differences between countries and help managers operate more effectively at the international level. The approach used here for Japan can be applied to other countries whose markets present opportunities or whose firms present competitive threats.[1]

The specific objectives of this chapter are to:

1. *Examine* the underlying factors – economic, political, social, and cultural – that underlie the distinctiveness of Japan, its business practices and its corporations.
2. *Understand* why Japan is a difficult but rewarding market for foreign firms to enter.
3. *Identify* key strengths and weaknesses of Japanese firms.
4. *Explore* the ongoing changes in Japan and the implications for Japanese firms, their collaborators and their competitors.

ACTIVE LEARNING CASE

Doing business in Japan

Japan is the third largest economy in the world after the United States and China. For this and other reasons it is attractive for foreign multinational firms, large and small. It is also very different from other countries – politically, economically and culturally – and these differences can present major challenges for market entrants.

There are a number of reasons for the imbalance in outward–inward trade and foreign direct investment in Japan. It is a tough, competitive market, characterised until recently by relatively closed interfirm business networks and a unique political, legal and institutional infrastructure. Surveys and case studies of foreign firms in Japan reveal the difficulties many of them have faced and how they have adapted to succeed. They also reveal how things have changed over the years.

Prior to the ‘lost decade’ of the 1990s, Japan was lucrative but expensive and relatively attractive but restrictive. The major problem for foreign firms was the high basic cost of operating in Japan, including office rents, a high tax burden, staff costs (for local personnel and expatriates), materials and other inputs. Firms also reported major recruitment problems and difficulties keeping good Japanese staff, partly because the lack of lifetime employment practices and poor social status meant that many Japanese were reluctant to work for foreign firms. Complex employment legislation and very different human resource management practices also added to the effort required to establish an effective local business.

A variety of market restrictions also faced firms, many stemming from the entrenched *keiretsu* networks, both upstream (between buyers and suppliers) and downstream (between producers, distributors and retailers). Most Japanese firms had long-term relationships with buyers and suppliers characterised by reciprocal trust rather than short-term contractual or price-based arrangements. Breaking these ties by doing business with outsiders could affect these local relationships, so despite the potential for short-term gains, it tended to be avoided. A wide range of government-related obstacles, including binding red tape and uncertain regulations pertaining to foreigners and foreign companies, also created additional constraints for foreign firms in Japan.

In some cases these barriers to foreign entrants were the result of active protectionism, by colluding firms and their trade associations and various other coordinating agencies, or by the Japanese government itself. In the late 1980s and early 1990s political lobbying over alleged restrictive practices, particularly by the US administration, was at its height. In 1989, for example, the Japanese government bowed to US pressure and reformed the Large Retail Store Law to allow Toys R Us to open a superstore. This was a high-profile case because of the bilateral negotiations between the United States and Japan that led to the change. Toys R Us went on to open 64 stores. But the Large Retail Store Law still remained to protect small retailers and indirectly supported the tied distribution networks of large *keiretsu*, creating additional barriers for foreign firms. Most recently, aided by further reforms to the legislation, Costco and Walmart from the United States (see the case **International Business in Action: Walmart takes Seiyu** later in this chapter) and Carrefour of France are aggressively challenging traditional network structures and attempting to eliminate costly local wholesalers.

More often than the direct actions of Japanese government agencies or collusion among corporate groupings, the above constraints for foreign firms in Japan simply stemmed from differences in Japanese business infrastructures, legislative mechanisms, management practices and consumer preferences. As with any overseas market, foreign firms have to adapt or they will fail to succeed. Foreign managers have also cited competition with Japanese companies and the strictness of orders from Japanese customers in terms of quality, delivery and after-sales service as key constraints in the past. But these are innate characteristics of doing business in Japan and two key reasons why Japanese firms themselves are so innovative. Successfully developing a business in Japan is an excellent test of a firm’s competitive advantages.

The extended downturn in Japan’s domestic market in the 1990s and early 2000s made it less attractive but easier to enter Japan. Government deregulation, the loosening of *keiretsu* ties and changing consumer preferences helped foreign investors. Foreign companies also cited falls in land prices, office rent and utility costs as specific improvements in the Japanese business environment. Similarly, reduced distribution costs and improvements in the availability of qualified personnel were also seen as important factors.

Source: Iain Masterton/Alamy Stock Photo

The Japanese government has taken steps to improve access for foreign firms, partly to increase consumer choice and stimulate spending and partly to expose local firms to outside competition. Policies aimed at tax reduction and favourable legal and institutional reforms, such as amendments to the Commercial Code of Japan, alongside improvements in labour market flexibility, have helped to increase FDI into Japan.

There are, however, more fundamental changes taking place that are probably more important for foreign entrants. The changing economic climate of the early and mid-2000s, particularly the high costs of manufacturing and depressed consumer demand, has resulted in a growing preference among consumers to buy cheaper, non-Japanese products and a need for Japanese firms to buy from abroad. Long-term *keiretsu* networks have loosened considerably, opening up supplier, distribution and retailing opportunities to foreign firms. Social and cultural changes also mean that younger Japanese are much more enthusiastic to work for non-Japanese firms, although senior, experienced managers are still relatively difficult to recruit.

More recent entrants to Japan and established foreign firms expanding their presence are a testimony to these changing conditions and the continued promise of the Japanese market. These include the French firm AXA Non-Life Insurance, Miele, the German household appliances company, and Dyson, the British vacuum cleaner manufacturer. Dyson Japan was established in 1998 and has seen a large increase in sales, achieving a 13 per cent market share by 2010. In 2013,

Dyson's global sales reached approximately $2 billion (¥230 billion), with Japan as its second largest market, accounting for 20 per cent of total sales. Vacuum cleaner sales have been booming in Japan and increased by 6 per cent from 2013 to 2014 with approximately 9.31 million units being sold. In 2019, Dyson announced that it would be moving its headquarters from the UK to Singapore, so that the firm is closer to some of its key markets in Asia.

The British retailer Tesco increased its commitment to the Japanese market by acquiring the neighbourhood supermarket business of Fre'c via its wholly owned subsidiary, C Two-Network Co. in 2004–05. It had already expanded successfully to control 77 stores since its initial entry in 1994, partly by buying C Two – Network in 2003. Tesco opened its first 'Tesco Express' in Japan in 2007, hoping to succeed by promoting its own brand, where many others had already failed. By 2011 it managed 140 stores, selling via both its Tesco brand and a local brand, Tsurukame. However, despite being the world's third largest retailer it was still struggling to develop its presence, and losses in sales inevitably led Tesco to leave the Japanese market in 2012.

According to a report from Japanese purchasing managers, in 2019, manufacturing and business confidence decreased in Japan, which was the first time since 2013. This can be explained because Japan's exports to China, which is Japan's largest trading nation, declined by 14.4 per cent. Analysts suggest that this was down to China's trade-war with the US. Moreover, in 2019, President Donald Trump stated that he would announce a new US–Japan trade deal later on in 2019.

Although there has been change in Japan, the key lessons from managers who have experienced this change also emphasise the continued importance of traditional Japanese practices. For newcomers they suggest the following:

- Research the culture, the market, the competition and the relevant network affiliations.
- Understand that in Japan more than any other market 'the customer is king', quality is paramount and a deep-rooted service philosophy is required.
- Be patient ('wait on the stone') and show long-term commitment; personal and corporate reputation is important and takes time to develop.

- Show sensitivity in all interaction: social gatherings are important and rituals and hierarchy have to be respected.
- Invest to adapt products, services, marketing and management style.
- Continually innovate, stay ahead of the competition.
- Use Japan to learn, to improve and to access other Asian markets.

Websites: http://www.jetro.go.jp/; http://www.tesco.co.uk; http://www.bccjapan.com; http://www.meti.go.jp/english/

Sources: Michael Kavanagh, 'Australia and Japan sales boost Dyson', *Financial Times*, 26 May 2010; Adam Gale, 'Dyson hoovers up Japan', *Management Today*, 16 September 2014; 'UK's Dyson chooses Tokyo for first store', *Nikkei Asian Review*, 17 April 2015; Justin McCurry, 'Tesco hopes for Express success in tricky market: Tesco opens first branded store', *Guardian*, 28 September 2007; 'Tesco plans to acquire Japanese business', Press Release, Tesco plc, 27 April 2004, at www.tesco.co.uk; 'Tesco to leave Japanese market after nine years', *BBC News*, 18 June 2012; S. C. Collinson, *Small and Successful in Japan: A Study of 30 British Firms in the World's Most Competitive Market* (London: Avebury Press, Ashgate Publishing Group, 1996); JETRO, *The 9th Survey on Attitudes of Foreign-Affiliated Companies toward Direct Investment in Japan* (Tokyo: Japan External Trade Organization, 2004), at http://www.jetro.go.jp/en/stats/survey/; JETRO, *Why Japan? Success Stories* (Tokyo: Japan External Trade Organization, 2004), at http://www.jetro.go.jp/en/invest/whyjapan/success_stories/; Milton Ezrati, 'Still The Wrong Answer In Japan', *Forbes*, 27 March 2019; Jennifer Epstein and Shannon Pettypiece, 'President Trump Eyes August for a U.S.-Japan Deal on Trade', *Bloomberg*, 27 May 2019.

1. **What kinds of challenges are foreign managers likely to meet when trying to set up a subsidiary office in Japan and recruit local employees?**
2. **How have *keiretsu* networks limited foreign firms entering the Japanese market in the past and how is this now changing?**

3. **As part of the general growth of foreign direct investment into Japan, why are foreign firms increasingly able and willing to engage in mergers and acquisitions (M&As) with local firms?**
4. **Despite widespread changes in Japan and the restructuring of Japanese corporations, why is it still important for foreign managers to understand something of the history and the context in which Japanese businesses have evolved?**

INTRODUCTION

Between 1950 and 1973 Japanese GDP grew at an unparalleled average annual rate of 8 per cent, over three times the growth rates of the UK and the United States in this period and similar to current growth rates in China. The OECD itself noted this by observing: ‘by the conventional measures of economic performance (income growth, inflation, unemployment) Japan has out-performed all other OECD economies since entry into the organisation in 1964.’[2] How did this happen?

From 1973 until the last half of the 1990s, Japan’s average rate of growth remained at 3 per cent per year. Then, it declined further, growing at half the OECD average (which was 2.8 per cent), and by the end of the 1990s it recorded unprecedented negative growth, shrinking by more than 2 per cent. More recently it has shown signs of recovery, but it is still undergoing a period of restructuring as it comes to terms with the end of a long era of continued growth and stability.

POLITICAL, SOCIAL AND CULTURAL CHARACTERISTICS

The 127 million people of Japan are heavily concentrated in the coastal areas and urban regions because of the mountainous nature of the country. Over half of the population lives in and around the three main metropolitan areas of Tokyo, Osaka and Nagoya, with Greater Tokyo having a population of 38 million. Figure 17.3 provides some basic data, alongside a map of Japan.

Up until the end of the 1980s Japan could be characterised politically, socially and culturally as a highly stable, conservative and homogeneous country. Economic change since then has been both driven by and a driving force for change across all of these dimensions. To understand the current dynamics affecting the Japanese market, its firms and its managers we must understand something of its political and social heritage.

A traditionally strong government role in the economy

The branches of the Japanese government are most similar to those in the United States: legislative, executive and judicial. Legislative power is vested in the Diet, which consists of a popularly elected House of Representatives and House of Councillors. The conservative Liberal-Democratic Party has been in power for most of the post-war period with the support of the powerful business and agriculture lobbies.

Executive power rests with the Cabinet, which is organised and headed by the prime minister, who is elected by the Diet. In addition to the office of the prime minister, there are 17 ministerial divisions in the executive branch. Judicial power is vested in the Supreme Court and there are eight high courts and numerous district courts throughout the country. Overall, Japan is

divided into 47 prefectures. Each local political subdivision, including cities, towns and villages, has its own executive power and operates within the scope of the national law.

Two key ministries were at the heart of Japan's post-war reconstruction, the boom years of rapid growth and, arguably, some elements of its more recent recession. The Ministry of Economy, Trade and Industry (METI), created in 2001, was previously the Ministry of International Trade and Industry (MITI), which was established in 1951. It was responsible for leading the selective liberalisation of the economy and trade particularly in the 1960s and 1970s. It used its strong control to target, promote and coordinate specific technologies and industry groups to spearhead the national economic development program. The **Ministry of Finance (MOF)** was also highly influential in steering the developing and internationalising economy via its control over prices and currency exchange in the early days of growth.

One of the more unusual systems that helped coordinate decision making and maintain the consensus among METI, MOF and various key flagship firms was the practice of **amakudari**. This involved the regular movement of senior politicians and civil servants from the public sector into private sector companies, often as highly paid consultants.

These two ministries connected with other ministries and government agencies to influence the evolution of specific forms of business infrastructure, corporate strengths (and weaknesses) and interfirm business practices. The Ministry of Post and Telecommunications (MPT) and METI, for example, jointly guided the development of NTT, the national telecoms carrier; its supplier group, including NEC, Fujitsu, Hitachi and OKI; and its de-nationalisation and partial break-up during the 1990s.[3]

The early 1990s saw the start of a series of restructurings in Japanese politics, following over a decade when government influence over the

economy and, in particular, the strategies of the major firms became increasingly weak. Both the lead political parties and the powerful civil service bureaucracies below them were pushed to justify their roles, responsibilities and connections with corporate Japan.

However, government in Japan still arguably plays a more important role in the economy and as an influence over corporate strategy than in other OECD countries. Agricultural and foods-related sectors, the construction industry and financial services, for example, are still very strongly influenced by government via a number of governance mechanisms.

Distinctive cultural characteristics

Although cultural factors are often overemphasised in discussions of Japanese economic strength, there are some distinctive social and cultural elements that underlie the country's success. As described in Chapter 5, the cultural frameworks of Hofstede and Trompenaars indicate a low level of individualism and a high level of uncertainty avoidance compared to Western cultures, reflected in the high priority placed on rituals, routines and procedures in organisations and society in general. The Japanese are relatively neutral or unemotional in the workplace and prefer more objective rather than subjective forms of decision making. They are also diffuse, in Trompenaars' terminology, with a high correlation between hierarchical relationships in the workplace and social status outside the workplace.

A strong sense of collectivism rather than individualism tends to dominate many aspects of Japanese life. Whether work related or outside work, clubs, groups and societies exist at all levels and people will tend to belong to several, with a distinct ranking in each according to its focus and their age and experience.

Within companies, certain characteristics have strong religious roots, including honour, respect, sincerity, loyalty (**chu**), duty, obligation or

responsibility (**giri**), ritual and hierarchy. These are all central pillars of Japanese society in general and are sometimes referred to as the Japanese Code. At various levels, parent–child relationships characterise the hierarchical nature of inter-organisational and interpersonal links, such as government–industry, large firm–small firm, manager–employee, and so on.[4] Respect for elders, ritualistic (and highly complex) language forms and behaviour, group activities and consensus decision making are all important elements. These contrast individualism and meritocratic forms of organisation and tend overall to unify the Japanese in their response to **gaijin** or outsiders.

Many of these characteristics are nurtured in the strong Japanese school system. This is characterised by a centrally regulated curriculum (dominated by Monbusho, the Ministry of Education, Science and Culture): conformist attitudes among pupils, teachers and parents; high standards; and a focus on factual learning and the sciences. As a result of this educational focus, Japan has double the number of scientists and engineers per head of population than the UK.

There is a significant amount of competition to get into good schools but a lack of competition between pupils once in school ('the nail that sticks out will be hammered down' is a local saying frequently used to describe this conformity). There is also a strong correlation between the level and place of education and job opportunities for school or university leavers, particularly at the top end of the business and civil service hierarchies: 50 per cent of Japanese school leavers attend university or higher education colleges and among about 780 universities and colleges about 604 are private.[5]

We get a small insight into the difficulties created for non-Japanese by the complexities of Japanese culture if we consider the **hai** dilemma. *Hai* can mean one of at least four levels of yes: recognition, but not necessarily understanding; understanding, but not necessarily acceptance and agreement;

responsibility, meaning understanding, but must consult with others and secure their agreement before acceptance; and agreement, which means understanding, agreement and acceptance. The non-verbal signals from the speaker have to be understood to determine which yes is being meant.

✔ Active learning check

Review your answer to Active Learning Case question 1 and make any changes you like. Then compare your answer to the one below.

1 What kinds of challenges are foreign managers likely to meet when trying to set up a subsidiary office in Japan and recruit local employees?

One way to answer this question would be to examine the political, economic and cultural issues in turn. Political challenges include the legislation for registering local companies, licensing, taxation, visas for foreign nationals and employment regulations. Economic challenges include the costs of premises and business services. But there are other costs, less easy to estimate, that result from the extra time and effort needed to develop customer relationships and adapt to Japanese business practices. All of the above challenges would involve a degree of cultural learning, given that they involve interaction with and an understanding of local people and organisations. Recruiting, managing and keeping Japanese employees, however, represents one of the biggest challenges for foreign managers. Failure to adapt human resource management practices, incentive schemes, the organisational structure and hierarchy, the definition of roles and responsibilities, and decision-making systems to develop an efficient, motivated local workforce undermines many foreign firms' market-entry strategies in Japan.

ECONOMY AND BUSINESS

Japan is very big and highly competitive. The unusual nature of its rapid growth in the early years stemmed from factors such as the traditional relationship between government and business, its unique capital markets (national finance and investment systems), its traditionally strong ***keiretsu*** groupings of firms, the role of the corporation in society, and the role of the employee in the firm. These are all linked to its unique social and cultural characteristics, leading many commentators to characterise Japan as having a different form of capitalism.

The size of the Japanese economy, combined with its productivity and the average wealth of its 127 million people, make it the third largest economy in the world after the United States and China. Other general characteristics include its large (though declining) trade imbalance and even larger imbalance in FDI, compared to its triad counterparts (see Tables 17.1 and 17.2).

This imbalance, coupled with the trade dependence on the US market, resulted in the long-running US–Japan trade conflict during the 1980s. Japan's growth period was marked by increased exports (still reflected in its export profile; see Figure 17.1) and outward FDI, but for some time its domestic market remained relatively closed to competitors for a variety of reasons. More recently, linked to the domestic market recession, imports of cheaper products, particularly from China, have created a more balanced trade profile (see Figure 17.2). Trade and FDI trends show that Japan's economy is becoming more integrated within the Asia region and developing particularly strong economic ties with China. Both output (market-oriented) expansion and input (resource or production-oriented) expansion

opportunities are being created for Japanese firms by the growth of the Asian economic region.

Table 17.1 Economic and trade data for Japan, 2009–17

	2009	2010	2011	2012	2013	2014	2015	2016	2017
GDP per head ($ at purchasing power parity)	32,607.87	33,747.64	34,312.11	35,600.73	36,793.194	37,389.79	37,883	38,282.50	39,002.22
GDP (% real change p.a.)	−5.0	4.7	−0.5	1.8	1.6	−0.06	1.2	0.6	1.9
Government balance (% of GDP)	−10.4	−10.4	−9.3	−9.8	−8.76	−7.24	−4.5	−5	−4.8
Inflation (%)	−1.3	0.72	−0.29	−0.04	0.36	2.80	0.8	−0.1	0.5
Public debt (% of GDP)	192.1	215.95	229.84	236.76	242.59	246.20	248	250.4	252
Hourly direct pay in manufacturing (US$)	n/a	26.01	29.25	28.94	n/a	n/a	n/a	n/a	n/a
Recorded unemployment (%)	5.6	5.1	4.6	4.4	4.00	3.58	3.4	3.1	2.8
GDP by sector	Agriculture: 1.1%, industry: 30.1%, services: 68.7% (2017)								
Exports	$694 billion (2017)								
Main exports	Motor Vehicles, Vehicle Parts, Integrated Circuits, Machinery, Industrial Printers								
Main export partners	China (19.5%), US (19%), South Korea (7.1%), Taiwan (5.7%), Hong Kong (4.7%)								
Imports	$632 billion (2017)								
Main imports	Oil & Mineral Fuels, Electrical Machinery, Industrial Machinery, Precision Instruments, Motor Vehicles								
Main import partners	China (24.5%), US (11%), Australia (5.8%), South Korea (4.19%), Saudi Arabia (4.14%)								

Sources: https://www.stat.go.jp/; http://www.jetro.go.jp/en/reports/statistics/; http://stats.oecd.org/#; http://www.imf.org/external/pubs/ft/weo/2015/01/weodata/index.aspx.

Table 17.2 Japan's inward, outward and net FDI by country/region, 2010–17 (balance of payments basis, net and flow, millions of US$)

	Japan's inward FDI by country/region						Japan's outward FDI by country/region						Japan's net FDI by country/region (outward-inward: balance of payments basis, net and flow, US$m)					
																		(Unit: US$ million)
	2000	2005	2010	2015	2016	2017	2000	2005	2010	2015	2016	2017	2000	2005	2010	2015	2016	2017
Asia	987	1,565	3,128	5,591	8,269	5,668	2,132	16,188	22,131	35,057	13,745	38,266	1,145	14,624	19,003	29,466	5,476	32,599
China	0	11	314	636	−93	966	934	6,575	7,252	10,011	9,453	9,679	934	6,564	6,937	9,375	9,545	8,713
Asia NIES	995	1,563	2,568	4,511	7,699	4,938	−686	4,902	6,902	11,962	−13,288	14,983	−1,681	3,339	4,334	7,452	−20,987	10,044
Hong Kong	568	960	698	983	1,486	−226	−132	1,782	2,085	2,761	2,185	2,121	−700	822	1,387	1,778	699	2,347
Taiwan	296	−26	21	703	2,476	743	−107	828	−113	598	1,482	1,485	−403	854	−134	−105	−994	742
South Korea	48	31	274	932	593	974	1,074	1,736	1,085	1,593	1,626	1,700	1,026	1,704	811	661	1,033	725
Singapore	83	598	1,575	1,893	3,143	3,447	−1,521	557	3,845	7,010	−18,581	9,677	−1,604	−41	2,271	5,117	−21,725	6,230
ASEAN4	−5	−5	235	433	667	−248	1,684	4,276	4,310	11,719	11,303	10,052	1,690	4,281	4,075	11,285	10,636	10,300
Thailand	−15	−6	9	335	662	−444	593	2,125	2,248	4,057	4,632	4,724	608	2,132	2,239	3,722	3,970	5,168
Indonesia	1	0	43	84	19	194	585	1,185	490	3,213	2,957	3,388	584	1,185	447	3,129	2,939	3,194
Malaysia	3	−0	184	−1	−25	−22	−4	524	1,058	2,918	1,394	935	−7	525	874	2,919	1,419	957
Philippines	6	1	(1)	16	11	25	510	442	514	1,531	2,319	1,006	504	440	515	1,515	2,308	981
India	0	1	4	24	−1	13	175	266	2,864	−1,041	4,105	1,060	175	264	2,859	−1,065	4,107	1,047
North America	−5	−636	3,014	4,313	6,303	5,738	14,176	13,168	9,016	51,451	53,327	52,879	14,181	13,804	6,001	47,138	47,024	47,141
U.S.A.	−1,052	308	2,961	4,338	6,293	5,831	14,121	12,126	9,193	50,218	52,584	51,981	15,174	11,818	6,232	45,881	46,291	46,149
Canada	1,048	−944	53	−24	11	−93	59	1,042	−177	1,232	744	899	−989	1,986	−231	1,257	733	992
Central and South America	2,895	1,278	(7,724)	−1,957	1,716	2,636	3,982	6,402	5,346	6,973	27,965	10,950	1,087	5,124	13,070	8,929	26,250	8,314
Mexico	0	0	(7,321)	6	−24	−5	377	629	688	1,229	1,872	1,201	377	629	8,009	1,223	1,897	1,206
Brazil	−1	1	2	44	48	−3	−323	953	4,316	−193	898	−3,593	−322	952	4,313	−238	850	−3,590
Cayman Islands	2,564	1,069	616	−2,313	1,387	2,688	3,660	3,915	−1,848	5,351	21,879	4,664	1,096	2,846	−2,464	7,664	20,492	1,975
Oceania	349	−114	(17)	−651	814	247	282	943	6,407	6,669	6,344	3,185	−67	1,057	6,424	7,320	5,530	2,938
Australia	357	−113	(6)	−660	745	252	152	640	6,371	5,676	4,696	2,213	−205	753	6,377	6,336	3,951	1,961
New Zealand	−9	1	(12)	6	−24	−32	96	62	−61	136	407	319	105	61	−49	130	431	351
Europe	4,013	1,123	204	−2,264	22,018	4,480	11,116	8,230	15,043	36,081	72,157	59,536	7,103	7,107	14,840	38,345	50,139	55,057
Western Europe	4,011	1,123	198	−2,282	22,012	4,438	10,950	7,509	14,450	35,278	71,601	58,948	6,939	6,386	14,252	37,560	49,589	54,509
Germany	1,899	237	2,206	−3,394	823	663	546	270	−321	3,925	1,714	4,670	−1,354	33	−2,527	7,319	891	4,007
U.K.	242	132	4,817	−1,527	5,601	−3,845	6,801	2,903	4,624	13,979	49,983	21,628	6,559	2,771	−193	15,506	44,381	25,474
France	2,285	−78	1,128	2,063	4,583	4,000	293	541	551	721	1,046	1,903	−1,992	618	−577	−1,342	−3,537	−2,098
Netherlands	1,688	2,541	(7,733)	1,568	4,147	3,946	2,276	3,315	3,288	10,070	9,019	18,552	588	774	11,021	8,502	4,872	14,606
Italy	−26	6	163	275	25	302	18	44	372	700	442	31	44	38	210	425	417	−271
Belgium	−23	−1,188	(479)	19	−126	−486	260	−195	−166	978	1,772	1,091	282	993	313	959	1,897	1,577
Luxembourg	173	363	381	441	836	370	−250	25	−108	3,051	827	4,779	−423	−337	−489	2,610	−8	4,409
Switzerland	97	−748	51	−14	968	1,203	−104	56	143	−394	2,162	2,441	−202	804	92	−380	1,194	1,239
Sweden	−23	−63	9	−617	−21	296	838	82	−623	2,126	311	1,021	862	146	−632	2,743	333	725
Spain	18	41	28	31	3	99	183	363	38	534	800	282	165	322	11	503	798	183
Eastern Europe, Russia, etc.	2	0	6	18	5	42	166	721	593	803	556	589	164	721	588	784	550	547
Russia	1	0	0	−1	3	4	15	95	350	468	108	15	14	95	350	469	106	11
Middle East	−6	9	(0)	228	159	62	−42	542	−348	767	752	2,044	−36	533	−348	539	592	1,982
Saudi Arabia	−3	0	0	0	2	0	−28	494	117	437	212	26	−25	494	117	437	209	26
U.A.E.	0	−1	0	255	222	115	−8	19	−498	74	308	712	−8	20	−498	−182	86	597
Africa	−7	1	36	−7	35	9	−192	25	−372	1,431	−435	1,726	−185	24	−408	1,438	−470	1,717
South Africa	0	0	0	−1	1	−3	12	−17	104	1,039	939	1,072	12	−17	104	1,039	939	1,075
World	8,226	3,223	(1,359)	5,253	39,314	18,840	31,534	45,461	57,223	138,428	173,855	168,587	23,308	42,238	58,582	133,175	134,542	149,747
Reference													0	0	0	0	0	0
ASEAN	76	592	1,810	2,324	3,814	3,203	207	5,002	8,930	20,920	−5,340	22,011	131	4,410	7,120	18,597	−9,154	18,808
EU	3,913	1,858	132	−2,104	21,057	3,082	10,968	7,872	8,359	35,785	69,122	56,845	7,055	6,015	8,227	37,889	48,066	53,763

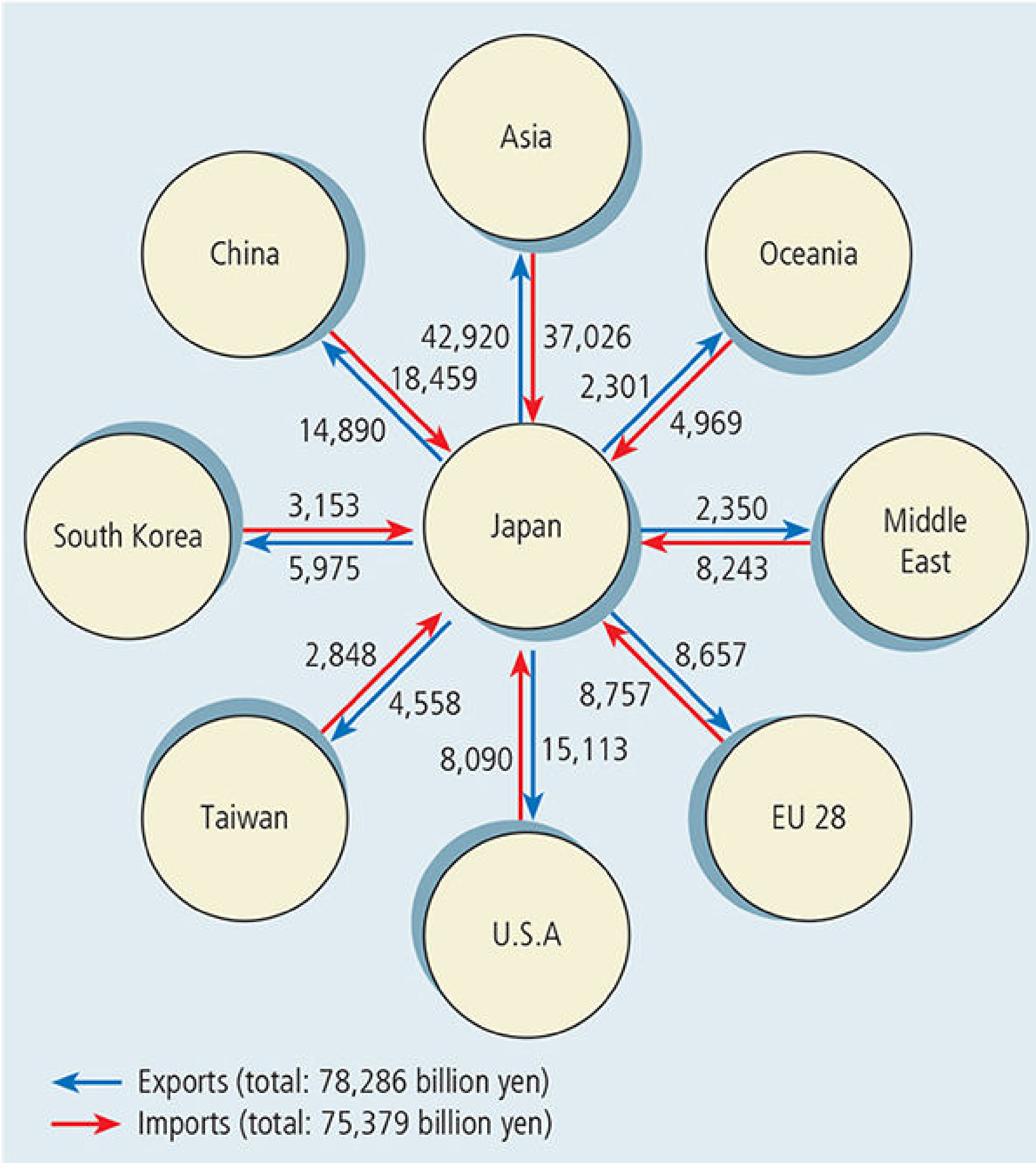

Figure 17.1 Japan's foreign trade by country/region, 2017

Source: Japan Ministry of Finance; https://www.stat.go.jp/english/data/handbook/pdf/2018all.pdf.

Japan is home to just over 50 of the world's largest 500 firms. The kinds of sectors represented in this list of top firms, together with Japan's trade profile and sources of outward FDI, all point to a surprisingly narrow range

of industry strengths. Its competitive superiority has always been limited to relatively few key sectors, as is the case for most other economies.

In the early 1990s just four industries – non-electrical machinery, electrical machinery, transport machinery and precision machinery – accounted for 75 per cent of total Japanese exports. Three product areas – motor vehicles and parts, consumer electronics, and electronic components – were responsible for about one-third of exports. The same industry niches were responsible for the growth of FDI (primarily in production activities) and of foreign sales of Japanese firms.[6] Other data also show how the success of Japanese firms, expressed in terms of the proportion of overseas to total sales, has also been rather limited.[7] Their size, as is the case for many US firms, reflects success in their large domestic and regional markets rather than their global competitiveness.

In his 1990 book *The Competitive Advantage of Nations*, Michael Porter uses Japan to illustrate both the importance of local *rivalry* and *demanding customers* as driving forces behind the evolution of innovative, competitive firms. As shown above, Japan's strong export performance is based on relatively few industries, initially steel and shipbuilding and heavy engineering, then later capital goods production, car manufacturing, electrical engineering and consumer electronics. In all these sectors very tough competition between many local firms battling for market share (rather than profits) pushed each competitor to develop new products, more rapidly at lower costs. The large number of firms in key industry sectors promoted this rivalry. During its rapid growth phase the country had, for example, nine indigenous car manufacturers (whereas the United States had only three), ten large electronics groups and over 115 companies producing machine tools, again far more per capita than the United States.

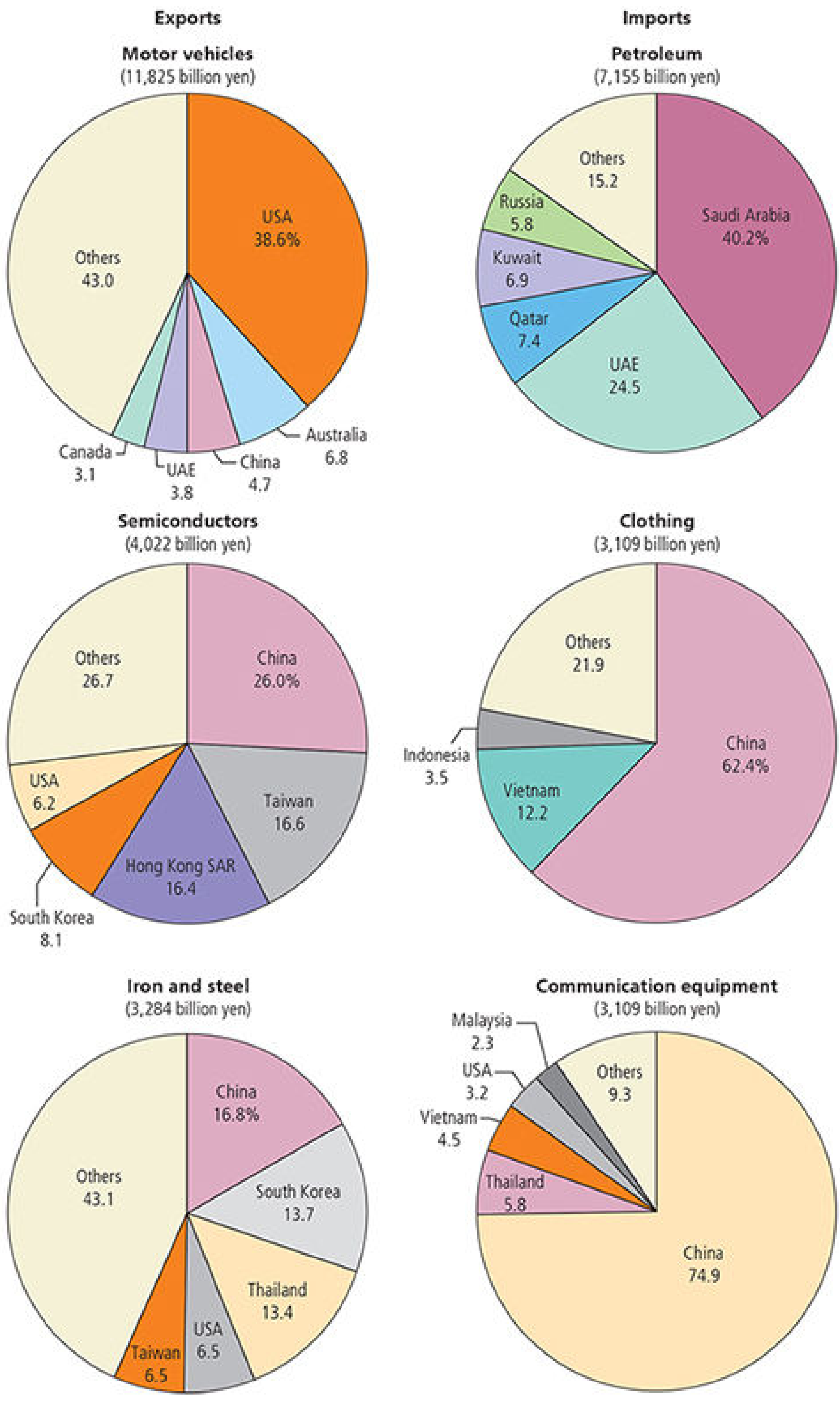

Figure 17.2 **Japan's major export and import commodities, 2017**

Source: Statistical Handbook of Japan (2018), p. 126, https://www.stat.go.jp/english/data/handbook/pdf/2018all.pdf.

Figure 17.3 **Japan, 2017**

Source: https://data.worldbank.org/country/japan; https://data.oecd.org/price/inflation-cpi.htm; https://www.statista.com/statistics/263700/unemployment-rate-in-japan/; https://knoema.com/atlas/Japan/Current-account-balance; https://data.worldbank.org/indicator/IT.NET.USER.ZS.

At the same time, tough markets and demanding customers at home pushed Japanese companies to cut costs and emphasise quality, personal service and buyer-led product customisation, all of which came to underlie their global competitiveness during later periods of export-driven growth. Toyota, for example, initially pioneered lean production techniques in the 1950s as a way of lowering costs to undercut local competitors, not to promote international competitiveness.

Japan and China: the new Asian powerhouse?

Trade and FDI flows between Japan and China are growing particularly quickly, raising the potential of a powerful axis of economic growth in Asia. The combination of Japan's technological leadership in specific industry sectors, its excellence in manufacturing and process innovation, its large, wealthy market, and its footholds in Europe and the United States, together with China's low-cost manufacturing base and its evolving, large but low-income market, sets the stage for a very strong regional partnership. However, the turbulent geo-political history and cultural and social differences between the two nations may well undermine this partnership, or at least limit the pace at which it develops.

Japanese imports from China have grown dramatically, particularly imports of IT products as China surpassed the US to become the major source of IT imports into Japan. Japan is also importing more motorcycles and consumer electronic products made by Chinese manufacturers. Exports from Japan to China have also substantially increased, partly due to buoyant demand for products such as automobiles. At the end of 2007, China overtook the United States to become Japan's major trading partner, accounting for over 17 per cent of exports. However, Japan's overall trade deficit with China remained at $18 billion. This lessened by the end of the decade as significant jumps in bilateral trade took place in 2010–11. It then

grew, as China began to import fewer products from Japan, $12.8 billion in 2019.

BUSINESS CHARACTERISTICS

Having explored some aspects of the political, social and economic environment in which Japanese firms have evolved, we now move on to examine some of the factors underlying Japan's economic success. This success in the 1970s and 1980s led to a fear among Western observers that the Japanese had developed an alternative model of market capitalism that would outperform incumbent firms in the United States and Europe. High-profile articles and books on the Japanese threat fed this fear.[8] This also prompted some useful, in-depth research that sought to understand what factors underpinned this success. These include distinctive strengths in manufacturing operations, strong applied research and development (R&D), the *keiretsu* corporate networks, and domestic distribution and retailing systems that connect companies and customers.

Manufacturing strengths

The most detailed comparative studies involving Japanese manufacturers have been carried out in the auto sector, looking, for example, at productivity, manufacturing efficiency, continuous process improvement, design quality, return on R&D and new product development. The success of Japanese firms in this sector is shown by the fact that on average (up until the end of the 1980s) they produced new models of cars with only 55 per cent of the engineering hours required by US and European manufacturers, maintaining development lead times that were over 15 months shorter, and sold the cars at a retail price that was, on average, 30 per cent lower than competing models from the United States and Europe.[9]

A variety of attributes underlie Japanese manufacturing competitiveness, and while detailed accounts can be found in numerous other sources, some of the main ones are listed here:

- Attention to quality (built in at every stage of development and production processes), often formalised in quality circles (QCs) and total quality management (TQM), but related much more to each individual employee's concern for flawless output.
- Strong manufacturer–component supplier linkages (coordinated initial development and subsequent innovation), again formalised within just-in-time (JIT) systems but reliant for their success on the close, informal *keiretsu* relationships between buyers and suppliers.
- Ability to cut production costs (using advanced manufacturing technology, JIT, and flexible and lean manufacturing techniques).
- A high level of automation and use of robotics (increasingly used to control costs as the yen appreciated).
- Higher degree of credibility and responsibility given to engineers and technical expertise.
- **Kaizen**, or continuous improvement, and a focus at all levels on incremental productivity improvement and customer-led product development.

Strong applied R&D

Japan has traditionally spent more than most other countries on R&D, consistently investing over 3 per cent of the nation's GDP on R&D. This compares to around 2.7 per cent in the US and less than 2 per cent on average in the EU28. The recent shift, however, has been the rise of China which overtook Japan in 2010 to become the second-largest R&D investor after the US. In Japan, however, over 75 per cent of R&D funding comes

from industry, the highest among OECD countries and higher than in China. Contrary to popular myth, the Japanese government has always spent relatively smaller amounts on R&D compared to other advanced countries (this is partly related to the low level of defence spending).

At one time Hitachi, Toyota, Matsushita, NEC and Fujitsu, the top five R&D spenders in Japan, spent as much (in terms of purchasing power parity) as the total R&D expenditure of the entire private sector in the UK. R&D was predominantly 'applied' or near-market R&D. Japan only started to catch up in terms of more basic blue-sky R&D, moving to the scientific frontiers in some technologies, in the last 15 to 20 years.

Keiretsu

The renowned Japanese corporate groupings, or *keiretsu*, characterised by cross-shareholdings and regular meetings between executives, represent more or less closely tied groups of integrated businesses. There are broadly two types of *keiretsu*, the horizontal (**kinyu**) type and the vertical, manufacturing *keiretsu*. Both are undergoing radical change, as described later in this chapter.[10]

Many of the former are descended from the pre-war **zaibatsu** conglomerates, which the allied forces attempted to break up in the late 1940s. Three of the top six are direct descendants of the pre-war *zaibatsu*: Mitsui, Mitsubishi and Sumitomo. The remaining three, Fuyo/Fuji, Sanwa and Dai-lchi Kangyo, are more like centralised holding companies. These top six alone directly accounted for about 5 per cent of the Japanese labour force and 16 per cent of total Japanese corporate sales in the early 1980s. But their cross-shareholding networks and their influence across and down the main corporate hierarchies in Japan were far more prevalent than these figures suggest.

The Fuyo *keiretsu* (*Fuyo-kai*) is shown in prior to its restructuring. It typifies the horizontal-type *keiretsu*, with a central bank and **sogo shosha**, or international trading company, and a diversified range of interests. These firms played a major role in bringing Japanese products to the world markets in the growth phase and underpin the global FDI network of many Japanese firms today.

Many of these Japanese banks once dominated the world rankings in asset terms, including Dai-lchi Kangyo Bank, Sumitomo Bank, Fuji Bank and Sakura Bank. Commercial banks in Japan have always been oriented more towards corporate clients than individual customers compared to Western banks. Unlike arm's-length shareholders in the West, with short-term repayment horizons, Japanese banks and other shareholders (usually affiliated companies, suppliers, distributors or associated companies) will have built a long-term commitment to supporting *keiretsu* member companies and their employees. As a result, capital markets in Japan have not traditionally emphasised return on investment (ROI) and dividends. Corporations have been much freer from the constraints and demands of shareholders and allowed to manage for long-term growth and continue *keiretsu* connections and loyalty to employees. This form of capitalism has significant benefits in a continually growing economy. But it also has weaknesses and can be an inefficient system for resource allocation as has become much more apparent in Japan's recessionary period. Subsequently, there have been fundamental changes to the structure of capital markets in Japan in recent years, as we will see below.

At one time Mitsubishi was said to be the most tightly woven *keiretsu*, based in Tokyo's business district, Marunouchi, which as a result was called Mitsubishi Village. It had over 216,000 employees in businesses ranging throughout the financial, manufacturing, services and trading sectors from heavy engineering and oil to aerospace and beer. The 29 companies at the

heart of the group held an average of 38 per cent of each other's shares, a high proportion even for Japanese corporate groups. These companies exchanged directors, cross-financed one another and engaged in joint investment and cooperative research projects for the benefit of the whole group. Information exchange and interfirm coordination are initiated at the most senior level and the presidents and chairmen of the (now 28) core firms still meet for lunch in Marunouchi on the second Friday of each month for the **Mitsubishi Kinyokai**, or Friday Club. Within the 28 core companies are an even closer-knit group, the members of which share the Mitsubishi name. The proportion of stable shareholders among this group stood at over 70 per cent in 1996 and has since fallen to about 30 per cent. The case **International Business Strategy in Action: Kirin Beer goes international** describes one of the companies in the Mitsubishi Group.

The newer, vertical *keiretsu* are headed by large manufacturers (Hitachi, Matsushita Electric Industrial, Toyota and NEC, for example) and tend to belong to a particular manufacturing sector. Here the relationships are between suppliers, a flagship manufacturer, and distributors and retailers, in a vertical value chain. Close information exchange, cross-shareholding, personnel exchanges and joint ventures support excellence in supply-chain management, new product development, standardised IT and logistics, quality and service assurance, and the sharing of management best practices.

At one time Matsushita, for example, had around 500 prime contractors, or first-level suppliers, and over 6,000 smaller suppliers at lower levels of what is known as a **co-prosperity pyramid** or cooperative manufacturing *keiretsu*. Toyota, by comparison, once had 168 first-tier suppliers, 4,000 second-tier and around 32,000 third-tier, according to one estimate. Small and medium-sized enterprises (SMEs) at the lower levels may rely on two or three top customers for over 50 per cent of their revenue, making them both highly cooperative (that is, willing to change component price or

specifications to the buyer's requirements at short notice) and very dependent on the fortunes of manufacturers further up the hierarchy.

Active learning check

Review your answer to Active Learning Case question 2 and make any changes you like. Then compare your answer to the one below.

2 How have *keiretsu* networks limited foreign firms entering the Japanese market in the past and how is this now changing?

The degree to which *keiretsu* networks will affect foreign firms' success in the Japanese market partly depends on which industry or business they are in. In the past, foreign entrants have found it very difficult to find willing suppliers or distributors because many local firms have been tied into long-term relationships with other *keiretsu* members. Traditionally these long-term relationships have meant that foreign firms will be disadvantaged when competing against local firms, regardless of the relative price or benefits of their product or service. Consumers and corporate purchasing departments have tended to show a strong bias towards local brands and local producers. Since the recession, however, price has become more important as a selection criterion and *keiretsu* structures have loosened, providing more opportunities for foreign firms. Imported products, discount stores (bypassing the complex distribution systems) and direct sales have all become acceptable. Japanese firms of all sizes are actively seeking links with firms outside their traditional networks and outside Japan as part of their changing business strategies.

INTERNATIONAL BUSINESS STRATEGY IN ACTION

Kirin Beer goes international

The establishment of the Japan Brewery Company, Ltd. in the late 1880s was a truly international affair. It involved, at various stages and in various roles, a Norwegian, an Englishman, a Scotsman and a number of Japanese, Americans and Germans. The symbol of the Kirin, a mythical Eastern cross between a horse and a dragon denoting good fortune, was chosen as its main brand from the start. The firm is the largest beer producer in Japan and one of the four dominant players in the industry alongside Asahi, Sapporo and Suntory. Its main products are Kirin Lager and Ichiban Shibori, with Kirin Tanrei as Japan's leading *happoshu* (low-malt) beer. Other beverages include canned coffee and tea, fruit juices and soft drinks. Also active in floriculture and pharmaceuticals, Kirin is part of the Mitsubishi *keiretsu*. In 2017, Kirin revenues were approximately $17,230 million, of which 56.4 per cent was generated in Japan.

In recent years the company has been having its share of problems. These all started back in the 1970s when Kirin held 70 per cent of the national market. At this time antitrust regulators decided to open the local market to other brewers. As a result, Asahi Beer quickly became the country's second-largest brewer, and since then Asahi has continued to erode Kirin's market share with (1) better product development; (2) a successful marketing strategy with commercials aimed at young, active individuals; and (3) a distribution network that introduced what turned out to be a growing trend among beer consumers – canned beer sold in large supermarkets.

In retrospect, one of Kirin's biggest mistakes was that it was too slow in reacting to competition in a market that it long took for granted. For example, despite Asahi's tactics, Kirin continued to rely heavily on its traditional sales approach and its long-established network of 'mom-and-pop' stores across the country. In truth, the company was confused regarding how to deal with competition and, as a result, made a number of mistakes. When the giant brewer decided to increase its marketing effort and create television ads directed at young people, the strategy was perceived by many viewers as a poor imitation of Asahi's own advertising strategy and the campaign flopped. As a result of such mistakes by Kirin, Asahi continued to gain market share and moved into top position with a 41.7 per cent share of the market for beer and *happoshu* in 2004.

Since then the two firms have continued to battle for market share. In 2019, Asahi was the seventh largest beer company in the world and Kirin was the ninth.

Partly in an effort to maintain its position in the Japanese market, Kirin has worked to exploit its traditional image. Kirin Lager, Japan's oldest brew, is now being promoted as the classic Japanese premium beer, the type of beer to enjoy with family and friends. And to promote this image with its other brews as well, Kirin has begun increasing its advertising budget. Unfortunately, this new effort faces a number of challenges. The biggest one may well be that most Japanese beer drinkers admit that all beers taste the same to them – so increased advertising may not generate the desired results.

Source: Trevor Mogg/Alamy Stock Photo

As well as competing actively for domestic market share, Kirin has expanded abroad. Today its products are available in 40 nations including the United States, the European Union, China, Taiwan and a host of other Asian countries. In most instances Kirin has teamed up with a local brewer. For example, the company entered into a partnership with Anheuser-Busch that allowed Kirin Beer to be brewed in Los Angeles and then shipped to the rest of the country. The company also holds a 46 per cent stake in Lion Nathan Limited, a subsidiary in Australia that has important operations in China. Kirin has also invested a 15 per cent stake in San Miguel Corporation, the dominant brewer in the Philippines. So the company is off to a good international start.

Competitors, however, are also expanding internationally, creating an ongoing need for product differentiation and good brand marketing. So Kirin still has a long way to go.

One of the things that may help the company is that it is part of Mitsubishi, Japan's largest *keiretsu*. As of 2018, the Mitsubishi Group had over 1,400 subsidiaries in 90 countries worldwide. Together Mitsubishi employed a global workforce of over 77,467 people. Although the members of this *keiretsu* operate independently, they can call upon one another for help. For example, when Akai Electric had financial problems, Mitsubishi Bank rescued it. When Mitsubishi Heavy Industries' shipbuilding business ran into trouble, it was able to find work at other group companies for those personnel who were laid off. And the cross-holding structure has also come in handy when warding off takeovers. For example, when Texaco bought Getty Oil, it was prepared to sell Getty's 50 per cent share of Mitsubishi Oil to Kuwait Petroleum. However, the members of the Mitsubishi Group got together and outbid the Kuwaitis for Getty's shares. The group has also made important acquisitions and struck major deals in a variety of areas. Mitsubishi companies have participated in the $940 million purchase of the Pebble Beach Golf Course in California, won a $400 million power plant deal in Virginia, and launched a $150 million futures trading joint venture in Chicago. Overall, Mitsubishi has hundreds of interdependent companies, and they are building an empire that stretches from Asia to Europe to the United States. With their help, Kirin may be able to become a major international brewer.

Websites: www.kirin.co.jp; www.mitsubishi.com; www.asahibeer.co.jp; http://www.beverageworld.com/beverageworld/headlines/; http://www.kirin.co.jp/english/annual2003/08source.html; http://www.wsj.com/articles/potential-brewing-giant-could-stir-up-japans-beer-market-1442490813; https://blog.technavio.com/blog/top-companies-global-beer-market; https://www.mitsubishicorp.com/jp/en/about/profile/

Sources: Naoko Fujimura, 'Asahi tops Kirin in Japan beer sales as demand falls', 17 January 2011, *Bloomberg Businessweek*; 'Asahi surpasses Kirin in beer sales', *Japan Times*, 12 July 2007; Emily Thornton, 'Japan's struggle to restructure', *Fortune*, 28 June 1993, pp. 84–8; 'Japan's beer wars', *The Economist*, 26 February 1998; 'A right old brewhaha in Japan', *The Economist*, 22 February 2001; 'Japan brewers' shipments rose slightly in 2004', *Kyodo News*, 18 January 2005, Kyodo

News International, Tokyo; Kirin Holdings Company Limited, *Annual Report*, 2010, 2014, 2018; Thomson Reuters, *OneSource*, 2010; Mintel Global Market Navigator, http://gmn.mintel.com/query/10884473/shares/region; Eric Pfanner and Atsuko Fukase, 'A brewing giant may stir up Japan's beer market', *Wall Street Journal*, 17 September 2015.

Distribution, retailing and customer orientation

Associated with the *keiretsu* industry groupings above are multi-layered distribution and retail networks in Japan. At its height, it was estimated that there was one retail outlet for every 75 people in Japan (over twice the US ratio) and over 476,000 wholesale stores. These are still organised both by region and by sector and product across Japan and tend to be geared to the large number of small retailers that serve the local markets. This 'tied' system of distribution, bound by strong face-to-face ties between sellers and buyers at each level, adds substantial costs to the final product. Again, at its peak, the American Chamber of Commerce in Japan (ACCJ) found that over 48 per cent of home electronics products in Japan are sold through exclusively affiliated stores, and about 99 per cent of cars are distributed through exclusive dealerships.

Many elements of this complex, high-cost distribution remain in Japan today. Ports in particular are notoriously protected and relatively slower and more expensive than in other OECD countries. The multi-tiered distribution hierarchy has become more simplified, however, driven by the growth in discount stores and cost-reduction measures.

Until recently, the strong patriotic preferences of the average Japanese consumer and, perhaps, the average Japanese middle manager responsible for company purchasing policy provided a firm basis for the country's industrial and distribution infrastructure. Outside the luxury or branded

consumer goods markets the Japanese have long had a strong preference for Japanese products.

JAPANESE CORPORATIONS

Japan is home to 52 of the largest 500 global firms (only the US and China have more). It is not just a large economy and a large market, but a major source of global competitors. Various stereotypes underlie popular beliefs about Japanese firms that are at best inaccurate and sometimes wholly misleading.

At one extreme, during the 1970s and 1980s, Japanese firms were seen to exemplify the best of all management practices. High-profile articles and books on the Japanese threat fed a general fear about the competitive threat they posed and prompted researchers to identify what was different about Japan and its firms and how such differences might convey sustained competitive advantages. At the other end of the extreme, the economic and corporate failures of the period from the 1990s to the late-2000s have prompted wholesale criticism of the Japanese model.

The truth lies somewhere in between. The Japanese economy, culture and business system underpin both relative strengths and weaknesses in Japanese companies. The former were very evident during the period of social and political stability and economic growth up to the end of the 1980s. The latter have become more apparent since then.

Very broadly speaking, two kinds of Japanese corporations have existed for some time. On the one hand those firms that have escaped the effects of the extended recession, such as Toyota, Honda, Sony, Canon, Sharp and Toshiba, have been less dependent on the Japanese market (more internationalised) for some time. They increasingly sold products in markets outside Japan, engaged in FDI abroad and evolved ‘less Japanese’ styles of management well before the recessionary period. They also represent the

industries in which Japan achieved its high levels of export competitiveness in the growth years, which is why we know more about them in the West.[11] On the other hand, a large number of firms, the majority of Japanese companies in fact, including firms like Nippon Steel, Sumitomo Chemical, Mitsubishi, Kajima and Dentsu, are less geographically diversified. They have long remained more dependent on the Japanese market, Japanese suppliers and Japanese ways of doing things.

Confirmation of this division came from the McKinsey Global Institute study which showed that, although labour productivity in Japan's top firms (such as those above) was 20 per cent higher on average than in US firms, they only represented 10 per cent of the Japanese economy. The other 90 per cent of Japanese firms had an average labour productivity that was 60 per cent of US levels.

Table 17.3 shows the top 25 Japanese firms in terms of revenues. All but a very few are highly dependent on their domestic market, in that they have less than 20 per cent of their sales in each of the triad regions outside their own. Despite the above-mentioned variations in the structures, strategies and management styles of Japanese firms, there are some common, distinctive characteristics of the stereotypical Japanese firm, relative to its European and American counterparts.

In one of the most extensive studies of the Japanese enterprise system, Fruin highlights high productivity, functional specialisation and manufacturing adaptability as the distinguishing hallmarks of Japanese firms. He identifies these attributes at three connected levels: the factory, the firm and the interfirm network.[12]

The various social, cultural and economic characteristics above combine to create certain strengths and weaknesses in Japanese firms. From a wide range of studies[13] we can distil some of the main characteristics of the generic Japanese management style, again traditionally:

- Effective communications internally and with outside firms (decentralised, horizontal information flows) and the use of **benkyokai** or cross-disciplinary, cross-business and cross-functional workshops.
- Less separation of R&D, design, manufacturing and marketing functions.
- Lifetime employment, low labour mobility and substantial investments in training. There is also a strong emphasis on on-the-job training and job rotation within the firm.
- Managers as problem definers, not fire-fighters, and as educators and mentors, not disciplinarians. This is underpinned by the weak links between performance and pay and the low wage differentials between workers and managers in the age-related hierarchy. Despite the importance of hierarchy and job titles, average CEO incomes in Japan are rarely more than ten times the salaries of new recruits. In the United States (and increasingly in the UK) there is a much bigger remuneration gap than this.
- Strong group/team ethic, loyalty, and motivation combined with competitiveness between teams.
- Strict formal hierarchy (based on seniority, rank and title) combined with strong underlying informal networks and a tendency towards consensus-based (**nemawashi** and **ringi**) decision making (horizontal promotion for high fliers and a lack of outsiders entering the firm at senior levels).
- General 'long-termism' with a focus on growth, employment stability and market share rather than profits and shareholder dividends.

Table 17.3 The 25 largest Japanese MNEs, 2019 ranking (billions of US$)

No.	Forbes Global Rank	Company	Sales	Profits	Assets	Market Value
1	#15	Toyota Motor	$272.1	$17.2	$465.6	$176.6
2	#36	Softbank	$86.2	$13.9	$332.3	$112.4
3	#43	Mitsubishi UFJ Financial	$53.7	$9.0	$2,799.9	$65.0
4	#51	Nippon Telegraph & Tel	$107.5	$8.7	$199.6	$80.2
5	#66	Japan Post Holdings	$115.6	$4.3	$2,619.7	$44.5
6	#67	Sumitomo Mitsui Financial	$52.5	$6.6	$1,841.1	$50.9
7	#73	Sony	$76.9	$7.3	$190.7	$60.1
8	#76	Honda Motor	$142.6	$6.6	$180.9	$50.5
9	#108	Mitsubishi	$127.4	$5.3	$153.2	$42.5
10	#125	Mizuho Financial	$33.1	$4.6	$1,837.8	$39.8
11	#132	Nissan Motor	$108.7	$4.4	$172.8	$33.6
12	#163	Tokio Marine Holdings	$47.7	$3.1	$212.1	$35.8
13	#170	KDDI	$45.8	$5.3	$65.2	$52.5
14	#182	Itochu	$91.6	$4 .0	$98.7	$27.5
15	#196	Mitsui	$56.6	$3.5	$107.8	$27.7
16	#221	Dai-ichi Life Insurance	$59.1	$2.9	$509.4	$16.9
17	#230	Hitachi	$85.8	$1.7	$88.4	$31.8
18	#249	Central Japan Railway	$16.8	$3.9	$83.3	$41.8
19	#250	East Japan Railway	$27.1	$2.7	$74.0	$34.7
20	#256	Denso	$48.8	$2.4	$51.5	$34.9
21	#257	JXTG Holdings	$101.8	$3.4	$80.9	$16.6
22	#263	MS&AD Insurance	$46.2	$2.1	$206.6	$18.0
23	#278	Seven & I Holdings	$61.5	$1.8	$52.1	$30.3
24	#286	Japan Tobacco	$20.1	$3.5	$49.8	$41.2
25	#291	Sumitomo	$46.9	$2.7	$72.7	$17.9

Source: https://www.forbes.com/global2000/list/#country:Japan.

These are obviously generalisations, but they are factors that tend to exist more or less in a wide range of Japanese firms. Overall, Japanese firms have a strong focus on human resources. A great deal of their strength (and a source of some weaknesses) lies in the employer–employee relationship and the commitment and loyalty shown by each to the other.

This overview of some of the key characteristics of the Japanese has been highly generalised, aiming to select factors that underpin significant differences in Japan relative to other countries. One of the best early books on Japanese firms and business practices, *Kaisha* (‘company’) by Abegglen and Stalk,[14] sums up some of these distinctive characteristics as the 3Ms:

- *Marketing*: direct links with consumers via retailers and wholesalers and strong customer-led product development.
- *Money*: cross-shareholding and the lack of outside pressure for short-term returns and stock price improvements.
- *Manpower strategy*: worker involvement, loyalty, effective teamworking and devolvement of responsibility combined with hierarchy.

A CHANGING NATION

The past decade has seen a number of major changes in Japan's social, economic and political structure, and this change continues. The added difficulties brought about in Japan by the current period of chaotic upheaval are partly related to the unusual degree of stability and consensus that the country experienced throughout a long high-growth era that is now over.

Starting in the early 1990s Japan experienced its worst economic recession in the post-war period. Slower growth, reduced investment, declining property prices and increased unemployment were all secondary effects of earlier declines in profitability, increased domestic costs and falling domestic demand. These were masked in the late 1980s by rapid growth rates based on strong exports and cheap capital, which ended abruptly when the bubble burst and **endaka** began. The recession was linked to the fast appreciation of the yen, which partly resulted from the 1985 **Plaza Accord** and continued through the mid-1990s, rising 24 per cent in value between early 1993 and early 1995.

Between 1990 and 2000, 'the lost decade', unemployment grew from 2.1 to 4.7 per cent; GDP growth fell from 5.1 to 1.9 per cent; motor vehicle production fell by 25 per cent; the sales of large department stores slumped by 13 per cent; and residential land prices in Tokyo dropped by 55 per cent. The knock-on effects continued for some time.

Alongside this economic slump, significant social and cultural developments have resulted in an unprecedented degree of tension between traditional and modern ways of living and working. Some of the broader elements of social change include the aging population, changing diet and changing health problems, a rising crime rate (though from a very low base

rate), new attitudes towards work and leisure, and, among some in Japan, a perceived decline in moral values (among others, a new freedom and social openness).

Some of the most obvious changes are seen in the buying patterns of Japanese consumers. Beyond a long-term move to Western foods and clothing styles there has also been a growing preference for 'value for money' and an increase in buying from previously frowned-upon foreign firms and discount retail stores. This is partly because of the recessionary pressure on wages but is also an indication that consumers are beginning to realise and object to the fact that Japan's consumer prices were well above the OECD average.

This change in consumer behaviour, alongside the increasingly price-oriented, cost-cutting objectives of manufacturers, has challenged the multi-layered distribution system that has dominated wholesale and retail networks in Japan. A flatter distribution system has begun to develop, pioneered by discount stores and direct importers.

We will now examine some specific aspects of change in Japan: the restructuring of the capital markets, deregulation, increased inward FDI and the restructuring of Japanese corporations.

Restructuring capital markets

The changing role of banks and the evolution of Japan's financial services industry created persistent instability in the corporate finance system. During the 1980s and 1990s there was a general move towards using capital markets (bonds and equity) for funding investment, particularly among large manufacturing companies in Japan. Partly as a consequence, banking relationships became less stable with far more companies taking loans from more than one bank and changing their main lender. Loose financial discipline in the high-growth, high-investment years resulted in heavy

depreciation charges, often on investments that resulted in overcapacity rather than bringing in extra revenue.

The scale of this instability only became clear after the bubble era when the collapse in property prices, which underpinned much of the private sector borrowing, left many companies in financial difficulties. Data on debt liabilities and bankruptcies showed that conditions were getting tougher for Japanese firms. This prompted widespread changes in corporate governance practices in Japan in the mid-2000s. Average return on equity in 1997 was around 4 per cent in Japan compared to 20 per cent in the United States, a contrast that preceded the recession but had been accepted as part of the financial system. But while US companies achieve average returns of around 4.5 per cent above cost of capital, from 1990 to the mid-2000s Japanese firms (on average) failed to meet the growing costs of capital (that is, they were 'value destroyers' rather than 'value creators').

As a result of these problems, a process of consolidation, rationalisation and mergers got underway in Japanese capital markets, partly forced on banks by government organisations, as financial deregulation continued (Figure 17.4). Disintermediation has taken place, with companies raising finance from capital markets rather than via traditional *keiretsu* cross-shareholding and bank relationships.[15] Private equity and venture capital also played a growing role, as did foreign investors.

Deregulation, increased M&A and inward FDI

Although external pressure to deregulate the Japanese from European and US corporations and governments has declined, the pressure from inside Japan has grown. Structural reforms, changes to government policy and the legal codes, plus the changing priorities of Japanese firms and customers have led to a significant increase in inward investment. In particular, foreign M&As, largely unheard of in the past, have grown substantially, as shown in

Figure 17.5, but these are still relatively less significant than in other advanced economies. The number of foreign takeover bids each year in Japan exceeded 100 for the first time in 2007, dipped in the following few years and has continued to grow since then.

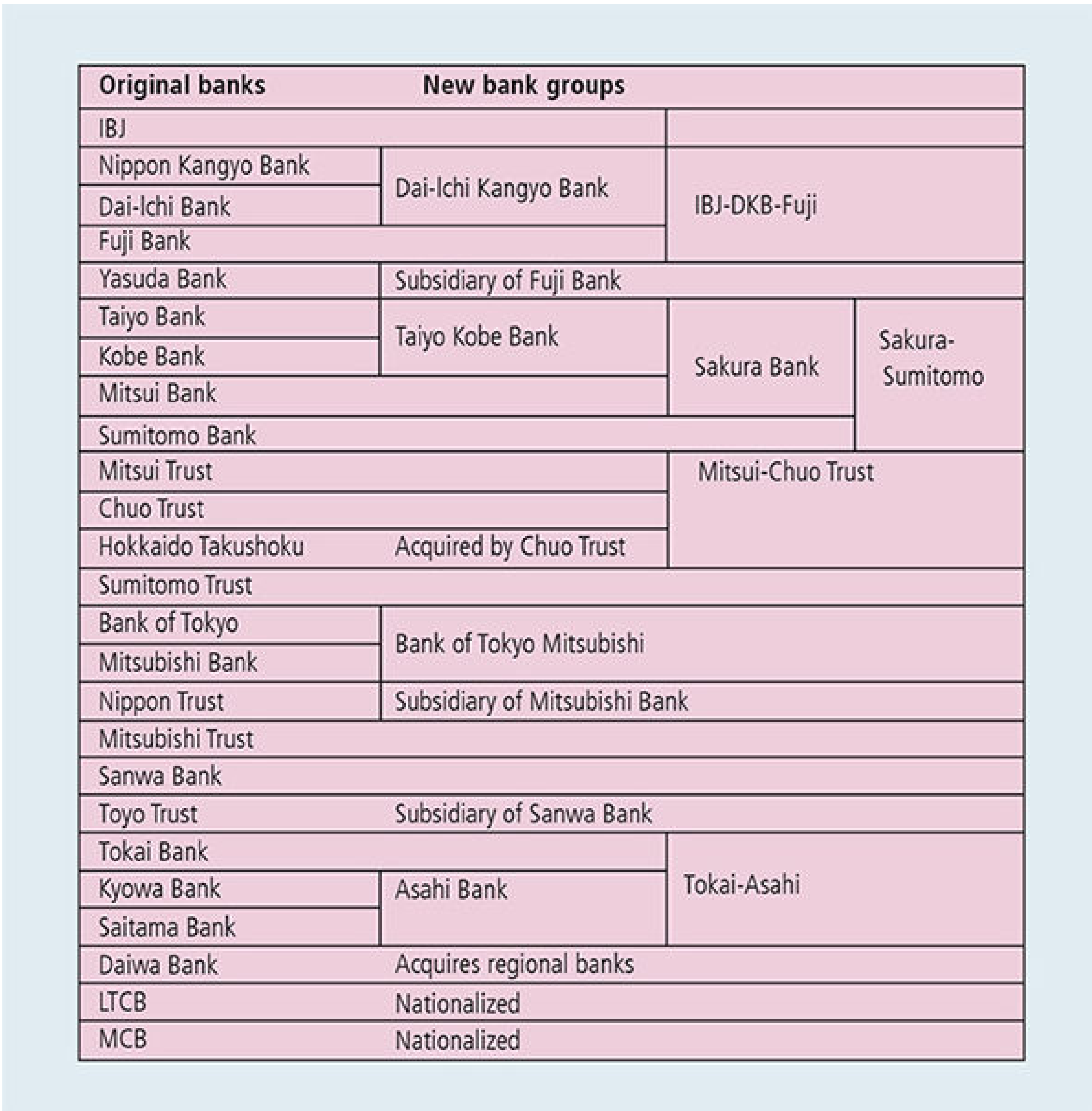

Figure 17.4 **Bank group consolidation in Japan**

European firms have significantly increased their investments in Japan. French firms were early investors in the late 1990s, making large

acquisitions in Japan's automobile, auto parts and finance/insurance industries. Renault's 36.8 per cent stake in Nissan in March 1999 contributed to this (see **Real Case: Renault, Nissan and Mitsubishi Alliance** at the end of this chapter). Three sectors – finance, transport equipment and telecommunications – accounted for a significant proportion of M&As. But foreign firms have also made attempts to buy into other sectors, including retailing (see the case **International Business Strategy in Action: Walmart takes Seiyu**).

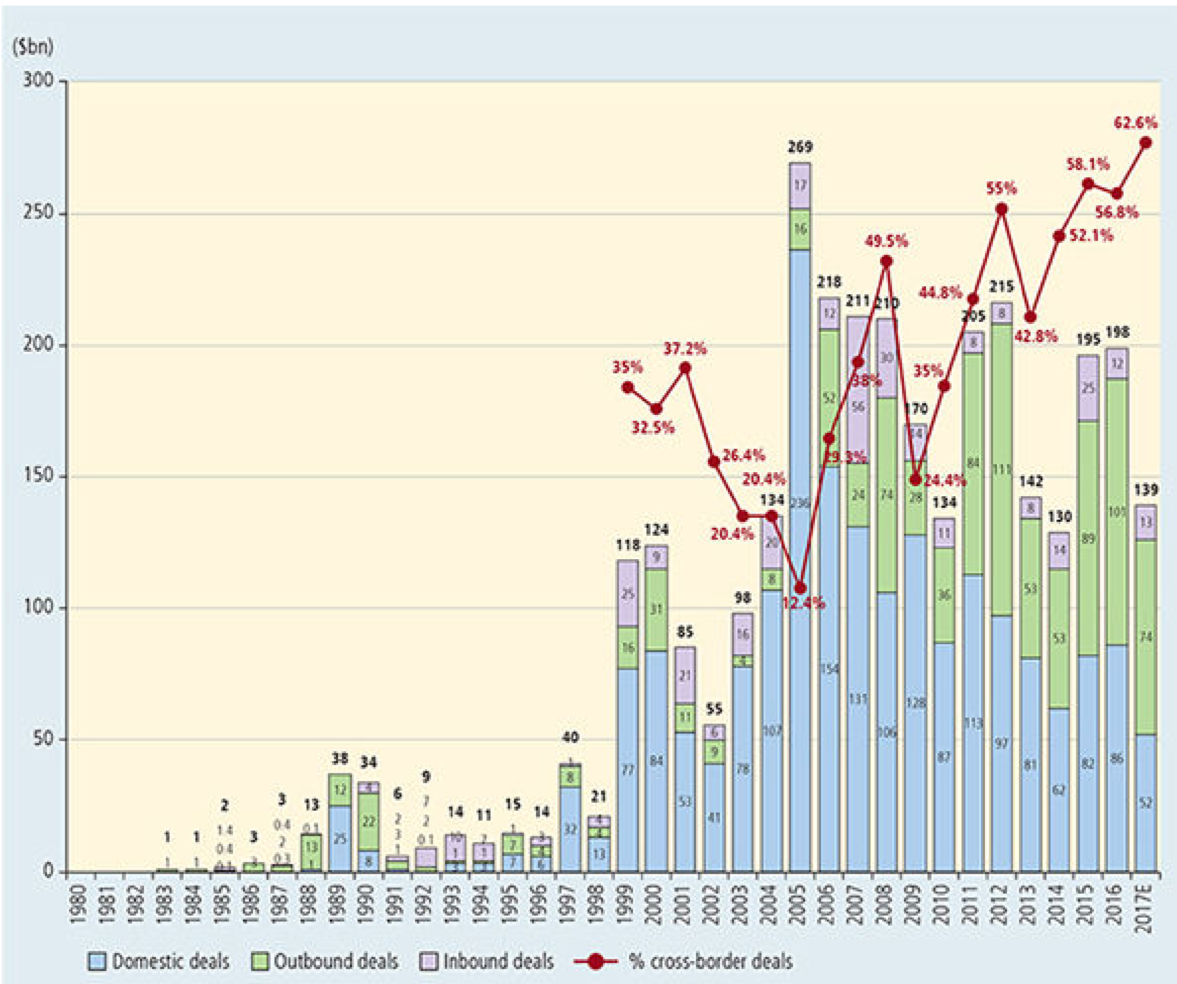

Figure 17.5 **Cross-border M&A activity in Japan, 1980–2017**

Source: https://www.jpmorgan.com/jpmpdf/1320736622067.pdf.

INTERNATIONAL BUSINESS STRATEGY IN ACTION

Walmart takes Seiyu

The Japanese landscape is littered with the remains of foreign firms that misjudged the local market. In March 2002, Walmart purchased a 6 per cent stake in Seiyu, the fourth largest supermarket chain in Japan, which has 393 stores selling food, clothing and general merchandise. The 2001 replacement of Japan's Large-Scale Retail Store Law, which prevented large retail developments, with the more generous Large-Scale Retail Store Location Law has eased Walmart's entry. It retained an option to slowly increase its ownership position in the company to 66.7 per cent by 2007. In 2003, after a five-month feasibility study on opportunities in the Japanese market, it took a step in that direction by agreeing to spend $420 million to raise its stake to 34 per cent, making Walmart the dominant shareholder. Finally, at the end of 2007 it bought out the remaining shares to become sole owner of Seiyu. (This became the subject of an unusual insider-dealing investigation in Japan in 2010.)

To its Japanese operations, Walmart brought a new management style, strategy, supplier networks and one of the world's most formidable information and distributions systems. With $244 billion in revenues, Walmart also brought the financial power to update Seiyu's ailing 400 stores. However, since 2003 Seiyu has continued to post annual losses.

Success in Japan's retail market remains anything but assured. The Always Low Prices strategy on which Walmart based its North American success must be adapted significantly to cater to the Japanese market. Japanese consumers insist on standards of quality that Walmart is simply not used to offering in other countries. When, in the early 1990s, the Japanese retail giant Ito-Yokado stocked Walmart biscuits in its stores, they were literally shunned because of their sickly taste and poor quality. Some 40 per cent of the biscuits in each packet were said to be broken. Ito-Yokado had to discontinue the product.

Further complicating Walmart's strategy is the resilience of Japan's complex supply system. Carrefour, which entered Japan in 2002, is a good example. The French firm has fallen well short of its original plan to persuade all its Japanese suppliers to adopt the Carrefour direct-purchasing system. This has reflected both a lack of familiarity on the part of Japanese suppliers with such a

system as well as the vice-like control over suppliers exerted by large Japanese retailers. Walmart's terrifying reputation for squeezing suppliers' margins until the pips squeak – and then some more – may also make it less attractive as a partner for local firms.

Walmart's success in the United States has also been based on low land prices and labour costs. The price of land in the outskirts of North American cities and suburbs has allowed the company to build large warehouse-style retail stores with huge parking lots. Japanese land, however, is significantly more expensive. Despite a recession and the stagnation of the Japanese economy, Japanese labour costs are among the highest in the world. That customers demand personal service does not help either. For similar-sized stores, Walmart will have to hire more retail workers in a Japanese store than in the United States.

Lessons learned by Carrefour show that Walmart will also have to differentiate itself from competitors. Carrefour positioned itself in the Japanese market simply as a discount retailer. With little to distinguish its product mix from those of its local rivals, the firm's stores underperformed, forcing a switch in strategy to emphasise its 'Frenchness'. It now offers a limited range of French products. After its initial stumble, the company expanded in Japan.

The emphasis on fresh produce in Japanese cuisine means that there is high demand for perishable goods and less for the kind of processed foods that are often the staple of Western discount supermarkets. This was also cited as one reason behind the sluggish sales at the US warehouse retailer, Costco, since it entered Japan in 1999.

Another cultural consideration is that the Japanese are hesitant to purchase bulk quantities even if it would save them money. The reason for this is rather simple. While the Japanese remain among the world's wealthiest consumers with a GDP per head of $32,481, they have on average only 35 m^2 of living space per capita, which is less than half of the Americas.

To date, Walmart has been finding ways to tailor its strategy to the Japanese market. The quality of its products has been raised enough to be acceptable. In renovated Seiyu stores, customers can see their sushi order prepared in front of them, as opposed to the pre-packaged variety offered in other countries. To lower land costs, Walmart's stores will have two floors instead of the traditional one floor. Labour costs have been reduced by cutting 25 per cent of its workforce through

voluntary retirement, saving $46 million on annual wages. It is also relying on its China-based suppliers to stock its Japanese shelves.

But other factors have added to the company's problems, particularly from Japan's continuing economic woes and the tough competitive environment. Uniquely in the developed world, consumer prices in Japan have been falling for some time. Growth has remained sluggish. Yet, that in itself might make this the right moment to enter the market. By the time the country starts to grow again, Walmart will have renovated stores, created new relationships with suppliers, linked all Seiyu stores to its computerised logistics system and learned enough about the Japanese consumer. Its choice of a local partner in the venture should have given it the benefit of local knowledge and a large store base. This is an advantage over other foreign retailers like Carrefour and Costco, which have chosen to build up stores from scratch. But other domestic and foreign competitors are readying up and Seiyu continues to lose Walmart money. In 2018, rumours surfaced in the media suggesting that Walmart was considering selling Seiyu, a sale worth around $2.8–$4.6 billion. However, in 2019, Lionel Desclee, Walmart's newly appointed chief executive, went on the record to state that he was not looking to sell Seiyu and that over the last few years Walmart has closed unprofitable Seiyu stores, implying that Walmart is operating in Japan to stay.

Websites: www.walmart.com; www.seiyu.co.jp; and http://www.jetro.go.jp/en/invest/whyjapan/success_stories/; https://www.japantimes.co.jp/news/2019/03/18/business/corporate-business/new-seiyu-ceo-says-walmart-not-looking-sell-japanese-supermarket-chain/#.XOvb1ChKg2w

Sources: Lindsay Whipp, 'Insider trade probe into Walmart-Seiyu deal', *Financial Times*, 5 November 2010; Hiroko Tabuchi and Kazuhiro Shimamura, 'Walmart expects bigger 2007 loss in Japan', *Wall Street Journal* – Eastern Edition, 13 February 2008, p. B14; Tak Kumakura, 'Walmart pushes for full ownership of Seiyu', *International Herald Tribune*, 22 October 2007; Walmart, *Annual Report*, 2004; 'Can Walmart Woo Japan?', *Business Week*, 10 May 2004; 'Walmart moves to control Seiyu', CNN.com, 12 December 2002; and 'Walmart's Japanese makeover', *International Herald Tribune*, 19 July 2004.

✔ Active learning check

Review your answer to Active Learning Case question 3 and make any changes you like. Then compare your answer to the one below.

3 As part of the general growth of foreign direct investment into Japan, why are foreign firms increasingly able and willing to engage in mergers and acquisitions (M&As) with local firms?

Deregulation by the Japanese government has helped to make it easier in recent years for foreign firms to acquire Japanese firms. Changes in capital markets, some driven by the government, have promoted inflows of foreign capital to reduce the debt burden. Japanese banks are also much more interested in M&A as a means to rescue (or hand over responsibility for) failing local companies. More significant factors are, first, the growing optimism among foreign firms regarding the future prospects of the Japanese market and their confidence in M&A as a means of access. Second, the rise in M&As can be partly attributed to the changing attitudes of senior Japanese managers who see foreign firms as a means to escape their current economic problems. M&As can help drive some of the strategic changes desired by Japanese managers, such as internationalisation and diversification. They can also help push through some of the necessary organisational changes, from de-linking from *keiretsu* relationships to changing internal hierarchies and reward systems.

RESTRUCTURING CORPORATIONS

High costs of labour and the domestic market dependence of most Japanese firms were among the factors that caused the initial recession, which Japan still struggles to escape from. Japanese managers had little experience of how to handle the radical restructuring and downsizing that became necessary, particularly the problem of labour costs that quickly began to erode domestic manufacturing competitiveness. Managers were particularly slow in reorganising to overcome their own office and administrative inefficiencies and this, combined with their reticence in cutting employees, resulted in the rapid collapse of corporate earnings at the start of the downturn.

The impact of the corporate restructuring was clear from the series of companies announcing job losses at the start of the 2000s, including Toshiba, Fujitsu, Mitsubishi and Nissan. Most firms cut their university recruitment programmes, pushing the unemployment rate for under-24-year-olds to over 10 per cent. Some of the largest bankruptcies hit the economy at the start of the decade, including the life insurer Chiyoda Mutual with debts of 2,900 billion yen and the retailer Sogo with debts of 2,000 billion yen.

Despite rationalisation, consolidation and a significant growth of M&As in key sectors, Japanese companies are still having to restructure their operations substantially in the face of longer-term pressures, including:

- more expensive capital;
- growing competition from low-cost Asian producers;
- declining prices of key manufactures, particularly electronics and autos;
- a slowing domestic economy; and

- growing inroads into the domestic economy by foreign competitors.

These developments had a knock-on effect as Japanese firms responded by restructuring internally and changing their interfirm trading relationships. The main changes are summarised below.

The decline of manufacturing and distribution *keiretsu*

Because a large proportion of Japanese SMEs are subcontractors to larger companies, within the multi-tiered hierarchies, recession and reorganisation among the giants have had a direct effect on a large number of SMEs. Restructuring effects, coupled with the appreciation of the yen, have passed on down this hierarchy, from primary (direct) subcontractors through second-, third- and fourth-level indirect suppliers. Automotive firms, including Mazda and Nissan, attempted to cut their first-line subcontractors (from 62 to 16 in Mazda's case), thereby passing on the responsibility for pushing down input prices to companies further down the chain. Both met with greater success in this slimming-down initiative after their respective mergers with Ford and Renault (see **Real Case: Renault, Nissan and Mitsubishi Alliance** at the end of this chapter).

The system of cross-shareholding has become increasingly diluted through reductions in mutual equity stakes. In their drive to cut costs, large manufacturing firms in Japan now avoid giving their usual suppliers a guaranteed volume of business over the long term but are encouraging them to compete with each other with a new emphasis on price as the deciding factor. More inputs are now bought from abroad so a more price-driven domestic market and freer flows of imports have evolved.

There has also been a decline in the use of exclusive agreements with single distributors or sales organisations. In the past these were the norm and in most sectors it was impossible to have multiple agreements or play

distributors and retailers against each other to push up sales. Increasingly now, multiple agreements are accepted and the trader–wholesaler–retailer link need not be tied but competitive, with many players competing at each level in a 'less imperfect' market.

The growth of outward FDI and offshore manufacturing

Nearly half of all cars and machines made by Japanese-owned companies are made outside Japan. It has been overtaken by China as the largest producer of automobiles and colour televisions (Japan is now a net importer). A telling example of the resultant pressures was Nissan's closure of its 30-year-old Zama car plant near Tokyo in March 1995, the first Japanese car plant to be closed since World War II. Ironically, part of the plant, which made 11.2 million vehicles in its lifetime, was turned into a pre-delivery inspection centre for Ford vehicles. Japan has become one of the leading foreign investors in China, with Japanese automotive and machinery firms increasing their investments into China and exports from China to Japan increasing as a result.

The decline of lifetime employment and changing HRM practices

Many of the changes being forced on Japanese managers are culturally taboo but economically inevitable. One of the most significant is the erosion of the lifetime employment system, which is very unlikely ever to return in its traditional form. Unemployment, traditionally very low and carrying a huge social stigma, officially grew to over 5 per cent (unofficial estimates put the peak nearer 8 per cent). It is now closer to 2.5 per cent as the economy plateaus to a more stable, though much lower level.

Early retirements, horizontal movement of employees, rising use of performance-related pay and significantly reduced wage increases and

bonuses at the annual wage negotiations in Japan also signified the new pressures on companies. The largest companies reduced their usual intake of university graduates and introduced merit-based remuneration schemes. These changes also had significant knock-on effects, not least the rise in the already high rate of suicides. In the long term, Japan will have an increasingly flexible labour market, with implications for all aspects of the traditional employee–employer relationship, in-house training and company loyalty (See Chapter 5 on 'International Culture' for more on Japanese work culture).

Diversification strategies

Diversification strategies have been the cornerstone of many corporate restructuring plans, some successful, others not. NKK, Japan's second-largest steelmaker, is a good example. Its previously loss-making marine engineering division turned in an operating profit of almost 15 per cent on sales of almost $100 million (although NKK overall expects to make a loss of five times this amount). The turnaround in this particular division was due to extensive (and risky) investments into areas outside shipbuilding. These include the leisure industry, manufacturing an indoor ski slope and once an artificial surfing beach (Wild Blue), using core technologies from NKK's own test divisions. In addition to diversification within manufacturing, the changing cost structure for industrial production has, in particular, accelerated the shift towards services.

✔ Active learning check

Review your answer to Active Learning Case question 4 and make any changes you like. Then compare your answer to the one below.

4 **Despite widespread changes in Japan and the restructuring of Japanese corporations, why is it still important for foreign managers to understand something of the history and the context in which Japanese businesses have evolved?**

Whether competing with Japanese businesses, collaborating with them, or working for them, their current practices and their distinctive strengths and weaknesses are the result of their historical development in the political, economic and social context of Japan. Their past is also the clue to their current restructuring, why it is necessary, and why it is not a quick and simple process. Managers in firms looking to enter the Japanese market need to know about the broader context of Japan because this provides insights into the role of government agencies, the business infrastructure, *keiretsu* networks, business etiquette, the culturally influenced preferences of customers, and the many other differences and difficulties that require adaptation. Japanese firms are a product of this unique environment; relatively few have broken away from their dependence on Japan's domestic market and most retain elements of traditional Japanese management practices. Foreign managers will better understand the strategic options and organisational challenges they face in alliances, joint ventures and M&As with Japanese companies if they know something of their home environment.

Several studies, including one by Michael Porter and colleagues, have examined the ongoing changes in Japan and analysed the challenges facing Japanese managers, to suggest the following guidelines for transforming the Japanese company:

- Create distinctive, long-term strategies. Rather than imitating close rivals, break out of the consensus and do something different.
- Expand the focus of operational effectiveness. That is, improve office-level productivity as well as plant-level efficiency.
- Learn the role of industry strategy in structure. Among a number of strategic changes, firms should avoid getting locked into price-based rivalry.
- Shift the goal from growth to profitability. Focusing on market share was only possible with 'patient capital' (linked to *keiretsu* and traditional capital markets); shareholder pressure will push for performance-related rewards.
- Reverse unrelated diversification. Pare down to your core competencies and let other firms do the rest.
- Update the Japanese organisational model. Change internal practices away from hierarchy and consensus towards meritocracy and entrepreneurship.
- Move away from incremental change. Become more flexible and responsive to suit the new competitive environment.

The few successful international Japanese firms, including Sony and Toyota, are seen as future models by many because they have adapted successfully to the new realities. In fact, it could be argued that their relatively high level of internationalisation prior to the domestic market recession gave them the necessary portfolio of overseas markets and sources of inputs, and the global scale and scope advantages needed to weather the local storms. Other firms have failed to adapt, often locked into cultural and institutional routines which were born out of the golden era of economic growth but which are ill-suited to the new realities.[16] Old habits die hard.

CONCLUSIONS

Japan continues in a period of fundamental political, economic and social transformation. Corporations have been forced by a drawn-out economic recession to alter radically the way they organise and invest. Foreign firms are finding, despite the depressed state of the Japanese market, that there are unprecedented opportunities for alliances and takeovers involving Japanese firms and for introducing new products and services to Japanese customers. There is a new period of internationalisation as Japanese firms shift investments out of Japan and attempt to reduce their dependence on local markets, while foreign imports, investment and M&As are on the increase. Partly because of the significance of the new trading partner and rising power, China, this amounts to processes of regionalisation rather than globalisation.

Much of this chapter has looked at the traditional way of doing business in Japan, the unique capital markets, *keiretsu*, demanding customers, lifetime employment and the traditional strengths and weaknesses of Japanese firms. The point of this is that these are enduring facets of Japanese business and they underlie the key distinctiveness that collaborators and competitors need to understand. They also continue to strongly influence the restructuring options open to Japanese firms and the changes in the economy as a whole.

James C. Abegglen, one of the most experienced Western commentators on Japan, sums up this tension between old and new in his book *21st Century Japanese Management: New Systems, Lasting Values*.[17] He describes how success comes from effectively combining the best of old and new. To do this requires some understanding of how adaptability can be promoted in the face of inertia. But it also demonstrates how any in-depth

country analysis must take account of the way that distinctive local economic, political, social and cultural characteristics have evolved in the past and will continue to influence *relative* business practices, markets and competitiveness in the future.

KEY POINTS

1. The current strengths and weaknesses of Japanese firms result from their evolution in a highly competitive but continually growing domestic economy with unique socio-cultural foundations.
2. The Japanese business environment was traditionally characterised by strong interfirm rivalry; ‘patient’ long-term finance, partly through cross-shareholding arrangements; *keiretsu* relationships, both vertical and horizontal; complex, multi-tiered distribution systems; demanding customers; and strong government intervention in the early years.
3. Socio-cultural factors that supported the Japanese way of doing business include ideals of obligation, loyalty, hierarchy and ritual, and a strong work ethic, linked to mainstream religion; a strong but conformist education system and ‘groupism’ plus consensus-based decision making in general; and complex language and tacit forms of communication.
4. Japanese firms are traditionally loyal to employees, who tend not to move from company to company; hierarchical and bureaucratic but also consensus oriented; good at integrating between functions and teamwork; good at applied R&D and training; long-termist; and close to suppliers and customers.
5. The Japanese market has traditionally been difficult for foreign investors to break into, partly because of the factors listed above and partly because of the system of governance that tends to favour local firms.

6 Japan is changing. Growing social and political heterogeneity alongside a prolonged economic recession is creating unprecedented tensions and forcing drastic corporate restructuring. *Keiretsu* families are loosening or breaking up; firms are diversifying and divesting; lifetime employment is declining; capital markets are heavily restructuring; and deregulation is the norm.

7 Changes in Japan are creating investment, M&A, and market-entry opportunities for foreign firms.

8 The growing regional Asian economy is centred on the major trading partnership between Japan and China.

Key terms

- **Ministry of Finance (MOF)**
- **amakudari**
- **chu and giri**
- **gaijin**
- **hai**
- **keiretsu**
- **kaizen**
- **kinyu**
- **zaibatsu**
- **sogo shosha**
- **Mitsubishi Kinyokai**
- **co-prosperity pyramid**

- **benkyokai**
- **nemawashi**
- **ringi**
- **endaka**
- **Plaza Accord**

REVIEW AND DISCUSSION QUESTIONS

1 List some of the factors underlying the competitive advantages of Japanese firms, developed during the rapid growth era of the 1960s, and 1970s.

2 What kinds of social and cultural characteristics of the Japanese underlie their proficiency in manufacturing?

3 How do *keiretsu* structures promote process and product innovation in Japanese firms?

4 Why have inflows of FDI into Japan historically remained lower than FDI outflows?

5 How would a foreign firm wanting to establish a sales and marketing operation in Japan need to adapt to succeed?

6 Why has the economic recession in Japan resulted in outflows of manufacturing investment?

7 What have been the main advantages and disadvantages for many Japanese firms of relying on domestic markets rather than internationalising?

8 How can we explain Japan's deepening trading relationship with China?

9 What has triggered the restructuring of capital markets in Japan, and what have been the effects on Japanese corporations?

10 How can an economy in recession present new opportunities for foreign investors?

11 What strategic and structural changes are many Japanese firms making in response to the changing economic and competitive environment they face?

12 Why have senior Japanese managers shown a growing admiration for some top foreign CEOs and management gurus?

REAL CASE

Renault, Nissan and Mitsubishi Alliance: no pain, no gain

In March 1999 one of Europe's biggest car makers, Renault, bought a 36.8 per cent stake in Nissan, Japan's second largest vehicle manufacturer. It has since increased its stake to 44.4 per cent with Nissan taking a reciprocal 15 per cent share in Renault. The alliance has deepened following the far-reaching changes put in place by Carlos Ghosn, installed as President and CEO of Nissan and now revered for having engineered a radical turnaround in the firm's fortunes. Although numerous alliances involving equity participation had taken place before this, notably the Ford–Mazda alliance, the Renault–Nissan case was seen to be a highly unusual foreign 'rescue' of a major Japanese firm in dire straits.

Nissan had made losses in six of the seven years prior to 1999, having been hit hardest of all the major car manufacturers in Japan by the decline in domestic sales and the rise in local manufacturing costs. Factory capacity utilisation had fallen to 53 per cent, and Carlos Ghosn, the new CEO of Nissan (known as 'le cost-killer'), set out to cut 21,000 jobs, close five factories, and cut the number of suppliers in half. Close, *keiretsu* relationships with suppliers and distributors were traditionally seen to be a key strength of Japanese manufacturers (Nissan had formerly been part of the Fuyo *keiretsu*), supporting high-quality products, process innovation, just-in-time supply systems and rapid, customer-led new product development. In a time of recession they represented an overextended supplier and dealer base, undermining profitability.

Internal restructuring also took place, following Ghosn's plan to introduce stock options and bonuses based on achievement and a performance-based promotions scheme, eventually for both employees and managers.

In the case of both external and internal reorganisation there are significant clashes with the traditional Japanese way of doing things. First and foremost, job losses represent an enormous problem for managers and employees alike, almost a personal admission of failure on both sides which has social as well as corporate repercussions. The ties of obligation and loyalty associated with lifetime employment are broken. Indirectly, the breakdown of *keiretsu* links with other firms

has a parallel effect, also resulting in job losses and the separation of long-term associations, which include personal friendships between managers and employees in both sets of firms.

Internal changes, particularly the introduction of performance-based remuneration and reward, are also radical in the eyes of the Japanese. Lifetime employment is associated with an age-related hierarchy where salaries only grow towards the end of a manager's tenure in the firm, as a reward for long years of service. To lose this reward, either because the firm no longer needs you or because the basis of remuneration is changed, is a drastic shift in the social contract employees entered into. Moreover, losing out to fast-track younger managers who rise up the hierarchy on the basis of their ability is not expected, particularly as talented managers may themselves have had to wait their turn in the past.

The steps taken by Renault change the rules of the game in Japan. Many would say that a sharp shock to push much needed restructuring was the only way. Renault's rescue was called for partly because of Nissan's accumulated losses, which could no longer be supported in a recession, particularly by investors who could no longer afford to ride the storm in a time when capital markets were tightening significantly. But it was also needed because of the inherent problems Japanese managers face in trying to drive such radical restructuring themselves. The senior managers responsible for six years of losses are still in charge alongside Ghosn, having 'saved face' because an outsider (a *gaijin*) forced the radical steps needed to turn the company around. Without this outside shock many Japanese firms remain locked into a certain way of doing things because forcing these kinds of changes from the inside on one's work colleagues and friends appears to be too costly. It threatens to destroy the social as well as the business fabric on which the country's impressive historic growth has been founded, and most Japanese do not want to be responsible for this kind of destruction, however creative it might be.

In 2016, Mitsubishi Motors joined the Renault–Nissan Alliance, which created the world's third largest organisation in terms of cars sold. This occurred because Nissan had purchased a 34 per cent stake in Mitsubishi Motors for around $2.2 billion. Although Mitsubishi generated profit in 2015, the firm was facing several scandals and concerns over quality. Moreover, its financial difficulties were down to Mitsubishi's tiny Kei cars, and a large proportion of these cars were

simply re-badged and sold as Nissans. This is a key reason why Mitsubishi sought a bail out from Nissan, as opposed to other organisations.

On reflection, the original alliance between Renault–Nissan represents the combination of two very different organisations, structurally and culturally. Renault was a strongly home-region-oriented firm, heavily dependent on its home economy, France. Alone it was relatively small, holding just 4.2 per cent of the global market, but vying with Volkswagen for European market leadership. Nissan was one of the unusual bi-regional auto firms, with strong sales in the United States and a relatively good market position in countries outside the triad regions.

Figure 17.6 shows the top 10 markets concerning the combined sales of all three firms in its top 10 markets. Figure 17.7 illustrates the individual sales of Renault, Nissan and Mitsubishi respectively. Accounting for just over 700,000 vehicles sold in its top 10 markets, Mitsubushi only accounts for a small share among the alliance. In 2017, the Renault–Nissan alliance sold approximately 6.4 million vehicles in its top 10 markets. These are similar-sized firms with very different geographic footprints that complement each other well. For the year ended 31 March 2018, Nissan acquired revenues of $110,476 million and employed around 140,000 people. Renault SA's revenue was $66,115 million and employed 181,344 people for the year ended 31 December 2017.

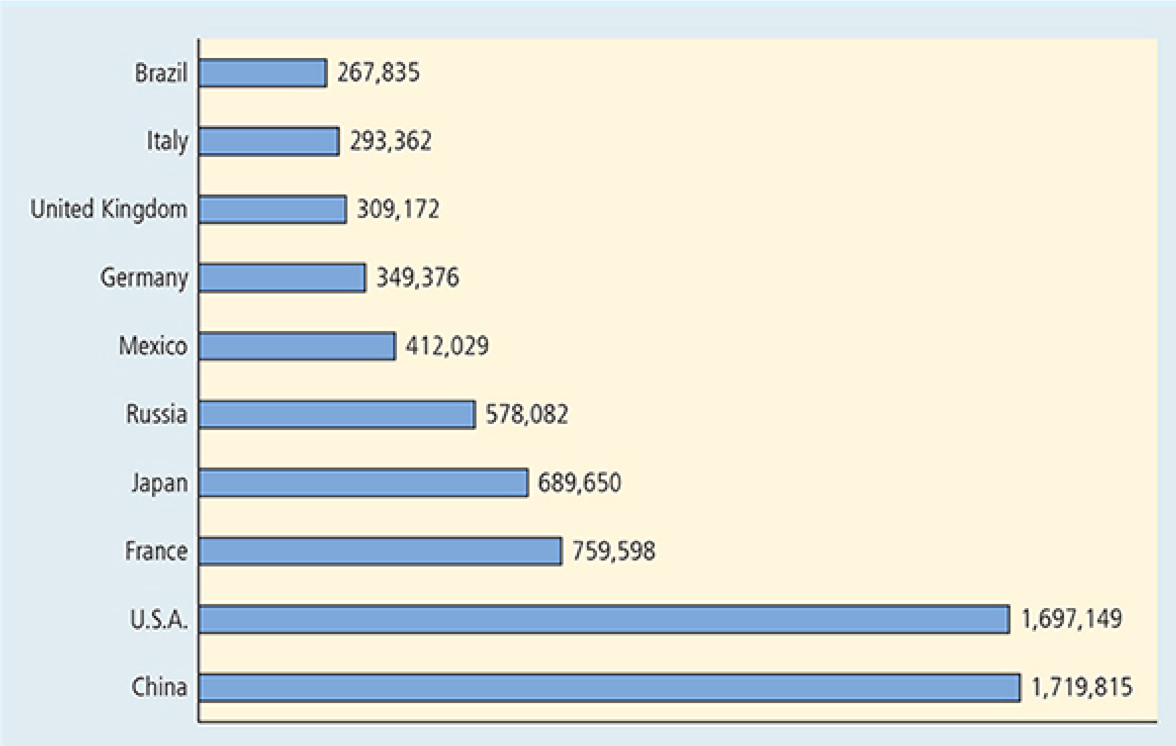

Figure 17.6 **Top 10 Renault–Nissan–Mitsubishi alliance markets, 2017**

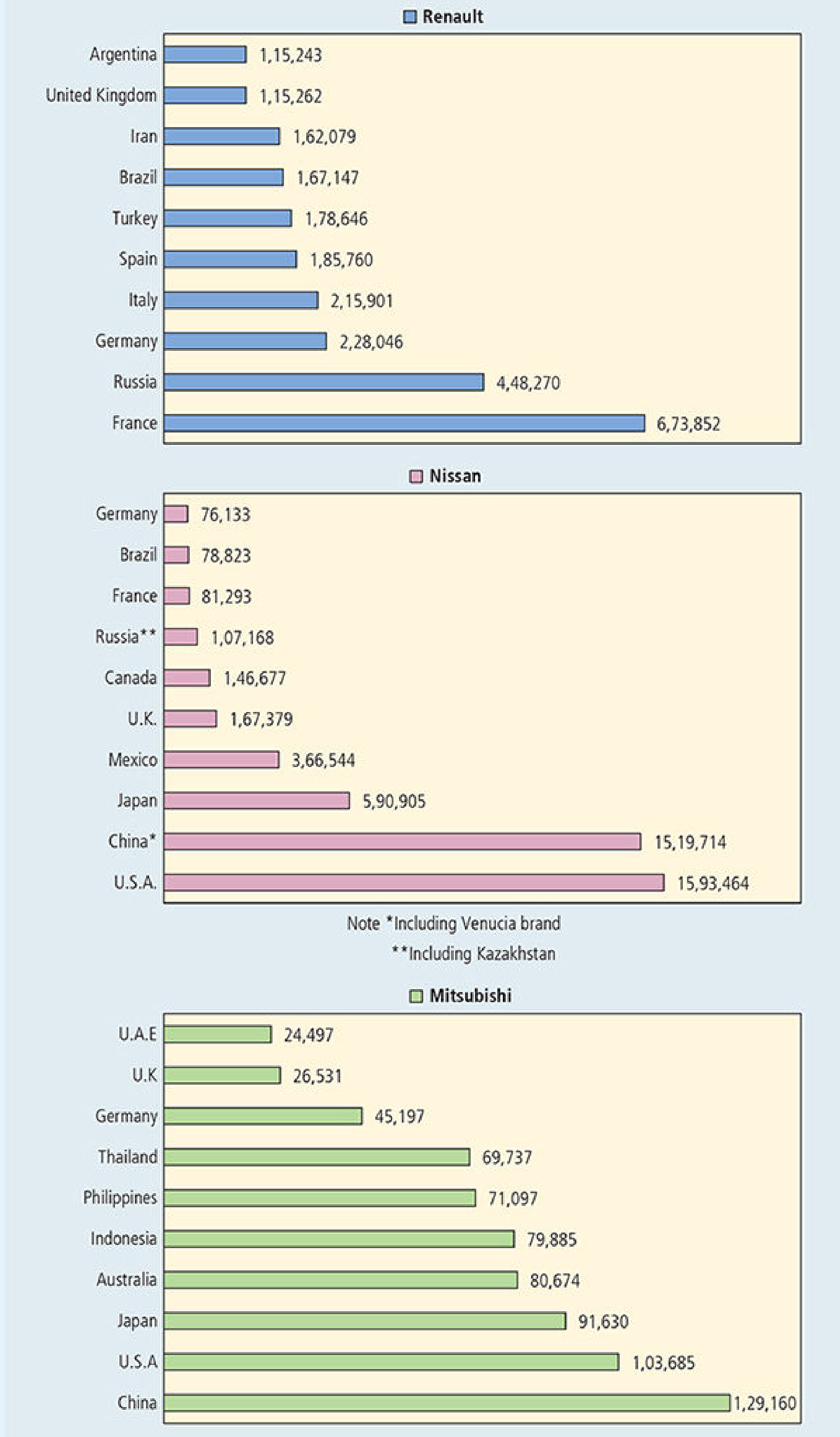
Renault
Argentina
1,15,243
United Kingdom
1,15,262
Iran
1,62,079
Brazil
1,67,147
Turkey
1,78,646
Spain
1,85,760
Italy
2,15,901
Germany
2,28,046
Russia
4,48,270
France
6,73,852
Nissan
Germany
76,133
Brazil
78,823
France
81,293
Russia**
1,07,168
Canada
1,46,677
U.K.
1,67,379
Mexico
3,66,544
Japan
5,90,905
China*
15,19,714
U.S.A.
15,93,464
Note *Including Venucia brand
**Including Kazakhstan
Mitsubishi
U.A.E
24,497
U.K
26,531
Germany
45,197
Thailand
69,737
Philippines
71,097
Indonesia
79,885
Australia
80,674
Japan
91,630
U.S.A
1,03,685
China
1,29,160

Figure 17.7 Top 10 Renault, Nissan and Mitsubishi markets, 2017

A similar pattern of differentiation is true for production. Nissan manufactures a large proportion of its vehicles in Japan with most of the rest spread fairly evenly among the United States, Mexico and the UK. It has industrial operations in 20 countries, including manufacturing sites in Taiwan, South Africa, Thailand, the Philippines and Indonesia. Renault manufactures in 17 countries but makes the majority of its vehicles in France and most of the rest in Europe.

Driven by an alliance board, chaired by the CEO of Renault, the two firms have developed shared production facilities in Mexico, Brazil and Spain; common engineering platforms for entry-level B segment and mid-level C segment vehicles; common powertrain parts and increased sharing of engines and transmissions; and increasingly integrated IT, information and communications systems.

Renault's competencies in marketing design, and financing complement Nissan's capabilities in engineering and manufacturing processes. Synergies are enhanced through the exchange of personnel. About 50 employees from Renault originally joined departments such as supplier relations, product strategy, sales and marketing, and finance in Nissan. Similarly, around 50 Nissan employees began work in the areas of quality control, vehicle engineering, manufacturing and powertrain in Renault. Beyond this, 250 executives from both firms were assigned to the permanent alliance structures, including cross-company teams and functional task teams, and a further 250 Nissan employees were part of the restructured European sales and marketing divisions of Renault.

The Renault–Nissan alliance is now heralded as one of the most successful in the business. In the first few years Nissan's $13 billion debt was substantially reduced and it achieved $2.3 billion profits in 2002. The market capitalisation of Renault increased threefold and of Nissan more than fourfold. Although the Renault–Nissan alliance has worked well, in 2018, Carlos Ghosn, who helped save both Renault and Nissan Motor, was arrested and detained in Japan concerning a case about his personal finances. More specifically, Ghosn's allegations concerned the filing of false statements to regulators regarding income ($80 million) from Nissan deferred until retirement. Moreover, Ghosn, has also been charged with aggravated breach of trust for acts, which comprises

of transferring personal investment losses to Nissan in 2008. Reportedly, the combined charges carry fines up to $90,000, and more importantly a potential maximum sentence of 10 years in prison. As of June 2019, the 65-year-old tycoon, is on bail, and is preparing for a trial which is expected to take place in 2020.

Websites: www.nissan.com.jp; www.renault.com; https://www.bloomberg.com/news/articles/2019-01-18/why-ghosn-s-still-jailed-and-what-it-says-about-japan-quicktake; https://www.thelocal.fr/20190427/ghosn-trial-may-be-delayed-until-next-year-japanese-media; https://www.topgear.com/car-news/mitsubishi-has-joined-renault-nissan-heres-what-you-need-know

Sources: 'Renault-Nissan Alliance facts and figures 2009', www.renault.com/renault_com/en/main; A. M. Rugman, *The Regional Multinationals* (Cambridge: Cambridge University Press, 2005); C. Ghosn and P. Ries, *Shift: Inside Nissan's Historic Revival* (New York: Currency Book/Doubleday, 2005); A. M. Rugman and S. Collinson, 'The regional nature of the world's automotive sector', *European Management Journal*, vol. 22, no. 5 (2004), pp. 471–82; R. Kelts, 'The cost killer cometh', *Japan Inc.*, October 2003; V. Emerson, 'An interview with Carlos Ghosn, President of Nissan Motors, Ltd. and Industry Leader of the Year', *Journal of World Business*, vol. 36 (2001), pp. 3–10; A. Hamey and T. Burt, ''Killer' to make unkindest cut', *Financial Times*, 18 October 1999; Pearson, *Renault Nissan Alliance 2004* booklet; Nissan, *Annual Report*, 2002, 2007, 2015, 2018; Renault SA, *Annual Reports*, 2002, 2007–14, 2018; Thomson Reuters, *OneSource*, 2011.

1 What broad economic and specific corporate pressures have resulted in the need for a radical shake-up of Nissan?

2 In the context of traditional Japanese employment and working practices and interfirm relationships, why are the changes being pushed by Renault's Ghosn considered radical?

3 What has accounted for Ghosn's success to date with the Nissan restructuring?

4 In what ways are the two companies better together?

REAL CASE

Sony – diversifying into the automobile industry?

When thinking of Sony one typically thinks of the Walkman and music players, televisions and other home entertainment products including the Playstation; however over recent years the nature of many of these industries has changed. Music players are no longer the lucrative business they once were as they have become part of the package offered in a smartphone, competition in the gaming console sphere has intensified after Microsoft entered the market with its Xbox, and even in the world of TV, Sony is not secure having seen its market share of the LCD market fall from 13.7 per cent in 2005 to around 7 per cent in 2019.

Source: Yaacov Dagan/Alamy Stock Photo

Smartphones are also an industry which Sony shows signs of divesting from after it stopped developing new smartphones for China and was expecting a 60 billion yen loss from the Xperia in the year to March 2016. It is important to note that while smartphones in general are not Sony's forte, they are one of the sectors key image sensor manufacturers.

Image sensors are the components which convert light into digital information, which in turn then defines the size and density of pixels, the number of megapixels and also the recording frame rate of an output. Sony produces a range of models with some of its higher end products used in

handsets such as the Galaxy Note 4. In fact, as its sensor business is doing so well, in June 2015 Sony announced that it was looking to increase its production capacity and would be issuing new shares to fund the strategy. Kenichiro Yoshida, Chief Financial Officer stated that the investment into image sensors would total just under $2 billion and in turn was expecting to increase its operating profit fourfold.

Not content with success in the smartphones arena, Sony had set its sights on cars with Shigeo Ohba, the general manager of Sony's image sensor business, predicting that the market for automotive image sensors will greatly increase between 2017 and 2030. It is the concept of self-driving cars which Sony is really planning ahead for, however, with the potential for up to 10 cameras to be installed in each vehicle. Despite the smartphone market exceeding sales of 1 billion units per year across the globe, in comparison just one camera can cost up to five times the price of one smartphone, signalling the potential profitability of the industry for Sony if manages to corner the market. With analysts predicting the demand for automotive cameras to reach 102 million units by 2020, the level of opportunity is clear.

The electrification of vehicles has certainly brought with it exciting prospects for component manufacturers such as Sony, but it seems that that might not be all. In February 2015 it was reported that Sony had purchased a stake in a Japanese start-up company which creates robot cars. In the deal, worth 100 million yen, it is expected that the two parties will work together to create a self-driving car. However it is not just Sony who appears to be considering venturing into the automotive industry, with Apple said to be pursuing the same strategy with reports of the tech giants snapping up experts to work on 'Project Titan'.

Sources: http://www.statista.com/statistics/267095/global-market-share-of-lcd-tv-manufacturers/; http://www.ft.com/cms/s/0/104c6a56-511e-11e5-8642-453585f2cfcd.html#axzz3lG9tr9j4; http://www.cnbc.com/2015/02/15/sony-follows-tech-peers-apple-google-on-the-car-road.html; http://www.insidercarnews.com/sony-might-be-building-your-next-car/; http://www.bloomberg.com/news/articles/2015-10-07/sony-ceo-hirai-says-electronics-turnaroundpast-midway-point; http://www.forbes.com/sites/ewanspence/2015/02/18/sonys-smartphone-surrender-abandoningthe-xperia/;

http://www.forbes.com/sites/marshallphelps/2015/10/17/how-driverless-cars-will-radically-changeevery-aspect-of-our-lives/; http://www.google.co.uk/url?sa=t&rct=j&q=&esrc=s&source=newssearch&cd=8&sqi=2&ved=0CD0QqQIoADAHahUKEwj69KW-1dbIAhWp9HIKHSl6AUE&url=http%3A%2F%2Fwww.informationweek.com%2Fit-life%2Fappleproject-titan-electric-car-may-arrive-by-2019%2Fd%2Fdid%2F1322280&usg=AFQjCNGQ3VmfPtWJPYoc1vWSLgVQyZZlSA&bvm=bv.105814755,d.bGQ; https://blog.technavio.com/blog/largest-tv-manufacturers-by-market-share.

1 Explain how Sony has diversified its product range in order to remain competitive?

2 Why has Sony been placing a greater emphasis on the automotive industry in comparison with the smartphone industry?

NOTES

1 This is a recognised approach in management theory. By examining the broader competitive environment within which firms evolve we can identify where specific differences and competitive strengths and weaknesses come from. Evolutionary theories of the firm (Peyton Young), contingency theory (Donaldson), and the theory of nationally bound administrative heritages (Calori et al.) all follow variations of this approach. L. Donaldson, *The Contingency Theory of Organizations* (London: Sage, 2001); R. Calori, M. Lubatkin, P. Very and J. F. Veiga, 'Modeling the Origins of Nationally-Bound Administrative Heritages: A Historical Institutional Analysis of French and British Firms', *Organization Science*, vol. 8, no. 6 (1997), pp. 681–96; and H. Peyton Young, *Individual Strategy* and *Social Structure: An Evolutionary Theory of Institutions* (Princeton, NJ: Princeton University Press, 2001). See also Collinson and Rugman, 'The Regional Nature of Japanese Multinational Business', in note 7 below, which applies such theories to explain the limited internationalisation of Japanese firms.

2 OECD, *Comparative Economic Performance in OECD Nations* (Paris: OECD, 1989), p. 66, http://www.oecd.org

3 M. Fransman, *Japan's Computer and Communications Industry* (Oxford: Oxford University Press, 1995).

4 C. Nakane, *Japanese Society* (Tokyo: Charles E. Tuttle, 1973).

5 https://www.japantimes.co.jp/news/2016/04/12/national/japans-public-private-universities-face-major-shakeup-mergers-student-numbers-fall/#.XN6otJNKhTY

6 R. D. Pearce and M. Papanastassiou, *The Technological Competitiveness of Japanese Multinationals* (Ann Arbor: University of Michigan Press, 1996); J. H. Dunning and J. A. Cantwell, 'Japanese Direct Investment in Europe', in B. Burgenmeier and J. L. Mucchielli (eds.), *Multinationals and Europe 1992* (London: Routledge, 1991).

7 S. Collinson and A. M. Rugman, 'The Regional Nature of Japanese Multinational Business', *Journal of International Business Studies*, vol. 39, no. 2 (2008), pp. 215–30; S. Collinson and A. M. Rugman, 'The Regional Character of Asian Multinational Enterprises', *Asia Pacific Journal of Management*, vol. 24, no. 4 (2007), pp. 429–46.

8 L. G. Franko, *The Threat of Japanese Multinationals: How the West Can Respond* (Somerset, NY: Wiley, 1983); M. J. Wolf, *The Japanese Conspiracy: Their Plot to Dominate Industry World-wide and How to Deal With It* (New York: Empire Books, 1983); W. G. Ouchi, *Theory Z: How American Business Can Meet the Japanese Challenge* (New York: Horizon Books, 1981); P. F. Drucker, 'Behind Japan's Success', *Harvard Business Review,* January/February 1981, pp. 83–90; E. F. Vogel, *Japan as Number One: Lessons for America* (New York: HarperCollins, 1979).

9 M. A. Cusumano and K. Nobeoka, 'Structure, Strategy and Performance in Product Development: Observations from the Auto Industry', *Research Policy*, vol. 21 (1992), pp. 265–93; J. P. Womack, D. T. Jones and D. Roos, *The Machine That Changed the World* (New York: Macmillan, 1990).

10 Sandra Dow and Jean McGuire, 'Propping and tunneling: Empirical evidence from Japanese keiretsu', *Journal of Banking & Finance*, vol. 33, no. 10 (2009), pp. 1817–28; Takehiko Isobe, Shige Makino and Anthony Goerzen, 'Japanese Horizontal Keiretsu and the Performance

Implications of Membership', *Asia Pacific Journal of Management*, vol. 23, no. 4 (2006), pp. 453–66.

11 Collinson and Rugman, 'The Regional Nature of Japanese Multinational Business', op. cit.

12 Fruin, op. cit.

13 M. Aoki and R. Dore (eds.), *The Japanese Firm* (Oxford: Oxford University Press, 1994); S. Clegg and T. Kono, *Transformations of Corporate Culture: Experiences of Japanese Enterprises* (New York: Walter de Gruyter, 1998); P. Haghirian, *Understanding Japanese Management Practices* (New York: Business Expert Press, 2010); H. Miyoshi and Y. Nakata, *Have Japanese Firms Changed?: The Lost Decade*, (Basingtoke: Palgrave Macmillan, Palgrave Macmillan Asian Business Series, 2010); M. Sako, *Japanese Labour and Management in Transition: Diversity, Flexibility and Participation* (London: Routledge, 1997); E. Westney, 'Japan', in A. M. Rugman and T. Brewer (eds.), *The Oxford Handbook of International Business* (Oxford: Oxford University Press, 2009); R. D. Whitley, 'Eastern Asian Enterprise Structures and the Comparative Analysis of Business Organizations', *Organization Studies*, vol. 11, no. 1 (1990), pp. 47–74.

14 J. C. Abegglen and G. Stalk, Jr. *Kaisha: The Japanese Corporation* (Tokyo: Tuttle Publications, 1985).

15 Nobuyuki Isagawa, 'A Theory of Unwinding of Cross-Shareholding Under Managerial Entrenchment', *Journal of Financial Research*, vol. 30, no. 2 (2007), pp. 163–79.

16 Collinson and Rugman, 'The Regional Nature of Japanese Multinational Business', op. cit.; See also: A. B. Keizer, *Changes in Japanese Employment Practices: Beyond the Japanese Model*, Routledge International Business in Asia Series (London: Routledge,

2011); P. Haghirian and P. Gagnon *Case Studies in Japanese Management* (New York: Business Expert Press, 2011).

17 James C. Abegglen, *21st Century Japanese Management: New Systems, Lasting Values* (Basingstoke: Palgrave Macmillan, 2006).

BIBLIOGRAPHY

Abegglen, James C. *21st Century Japanese Management: New Systems, Lasting Values* (Basingstoke: Palgrave Macmillan, 2006).

Allen, Linda, Chakraborty, Suparna and Watanabe, Wako. 'Foreign direct investment and regulatory remedies for banking crises: lessons from Japan', *Journal of International Business Studies*, vol. 42, no. 7 (2011).

Chung, C. C., Lee, S-H., Beamish, P. W. and Isobe, T. 'Subsidiary expansion/contraction during times of economic crisis', *Journal of International Business Studies*, vol. 41, no. 3 (2010).

Colcera, E. *The Market for Corporate Control in Japan: M&As, Hostile Takeovers and Regulatory Framework* (New York: Springer, 2010).

Collinson, Simon C. and Rugman, Alan M. 'The regional nature of Japanese multinational business', *Journal of International Business Studies*, vol. 39, no. 2 (2008).

Dent, C. M. *China, Japan and Regional Leadership in East Asia* (Cheltenham: Edward Elgar, 2010).

Dominici, G. *From Business System to Supply Chain and Production in Japan: Lean Production and its Roots in Japanese Business Culture* (Saarbrücken, Germany: VDM Verlag, 2010).

Dyer, J. and Chu, W. 'The determinants of trust in supplier–automaker relations in the US, Japan, and Korea: a retrospective', *Journal of International Business Studies*, vol. 42, no. 1 (2011).

Furuya, N., Stevens, M. J., Bird, A., Oddou, G. and Mendenhall, M. 'Managing the learning and transfer of global management competence: antecedents and outcomes of Japanese repatriation effectiveness', *Journal of International Business Studies*, vol. 40, no. 2 (2009).

Gao, Gerald Yong, Tan Wang, Danny and Che, Yi. ‘Impact of historical conflict on FDI location and performance: Japanese investment in China’, *Journal of International Business Studies*, vol. 49, no. 8 (2018).

Hasegawa, Y. and Kimm, A. *Rediscovering Japanese Business Leadership: 15 Japanese Managers and the Companies They’re Leading to New Growth* (Chichester: John Wiley & Sons, 2010).

Hatani, Faith. ‘Institutional plasticity in public-private interactions: Why Japan’s port reform failed’, *Journal of World Business*, vol. 51, no. 6 (2016).

Herstatt, C., Stockstrom, C., Tschirky, H. and Nagahira, A. *Management of Technology and Innovation in Japan* (New York: Springer, 2010).

Hong, Jacky F. L. and Snell, Robin Stanley. ‘Knowledge development through co-opetition: a case study of a Japanese foreign subsidiary and its local suppliers’, *Journal of World Business*, vol. 50, no. 4 (2015).

Horn, Sierk A. ‘Subsidiary capacity building in emerging markets: How Japanese MNEs sequence market entry and development strategies in India’, *Thunderbird International Business Review*, vol. 58, no. 1 (2016).

Iriyama, Akie, Kishore, Rajiv and Talukdar, Debabrata. ‘Playing dirty or building capability? Corruption and HR training as competitive actions to threats from informal and foreign firm rivals’, *Strategic Management Journal*, vol. 37, no. 10 (2016).

Ito, K. and Rose, E. L. ‘The implicit return on domestic and international sales: an empirical analysis of US and Japanese firms’, *Journal of International Business Studies*, vol. 41, no. 6 (2010).

Kang, Inwon, Han, Shin and Shin, Geon-Cheol. ‘A process leading to strategic alliance outcome: the case of IT companies in China, Japan and Korea’, *International Business Review*, vol. 23, no. 6 (2014).

Kawai, Norifumi and Strange, Roger. ‘Subsidiary autonomy and performance in Japanese multinationals in Europe’, *International Business Review*, vol. 23, no. 3 (2014).

Kim, Young-Choon, Lu, Jane W. and Rhee, Mooweon. ‘Learning from age difference: interorganizational learning and survival in Japanese foreign subsidiaries’, *Journal of International Business Studies*, vol. 43, no. 8 (2012).

Kotabe, M., Mol, M. J. and Ketkar, S. ‘An evolutionary stage model of outsourcing and competence destruction: a triad comparison of the consumer electronics industry’, *Management International Review*, vol. 48, no. 1 (2008).

Magnier-Watanabe, Rémy and Lemaire, Jean-Paul. ‘Inbound foreign direct investment in Japan: A typology’, *International Business Review*, vol. 27, no. 2 (2018).

McGuire, Jean and Dow, Sandra. ‘The persistence and implications of Japanese *keiretsu* organization’, *Journal of International Business Studies*, vol. 34, no. 4 (July 2003).

Nakauchi, Motohiro and Wiersema, Margarethe F. ‘Executive succession and strategic change in Japan’, *Strategic Management Journal*, vol. 36, no. 2 (2015).

Park, Tae-Hoon. ‘Hierarchical structures and competitive strategies in car development: inter-organizational relationships with Toyota’s first-, second- and third-tier suppliers’, *Journal of Asian Business and Management*, vol. 6, no. 2 (June 2007).

Rose, Elizabeth L. and Ito, Kiyohiko. ‘Competitive interactions: the international investment patterns of Japanese automobile manufacturers’, *Journal of International Business Studies*, vol. 39, no. 5 (2008).

Rosenbluth, F. M. and Thies, M. F. *Japan Transformed: Political Change and Economic Restructuring* (Princeton, NJ: Princeton University Press, 2010).

Slater, Stephanie and Robson, Matthew J. ‘Cultural interpretations of destructive acts and trust in Japanese supply channel relationships’, *International Business Review*, vol. 21, no. 3 (2012).

Wan, William P., Yiu, Daphne W., Hoskisson, Robert E. and Kim, Heechun. ‘The performance implications of relationship banking during macroeconomic expansion and contraction: a study of Japanese banks’ social relationships and overseas expansion’, *Journal of International Business Studies*, vol. 39, no. 3 (2008).

Witt, M. A. *Changing Japanese Capitalism: Societal Coordination and Institutional Adjustment* (Cambridge: Cambridge University Press, 2008).

Witt, M. A. and Redding, G. ‘Culture, meaning, and institutions: executive rationale in Germany and Japan’, *Journal of International Business Studies*, vol. 40, no. 5 (2009).

Zhonghua, W. and Delios, A. ‘The emergence of portfolio restructuring in Japan’, *Management International Review*, vol. 49, no. 3 (2009).

WWW RESOURCES

Japanese Ministry of Economy, Trade, and Industry: http://www.meti.go.jp/english/

Japan External Trade Organization: http://www.jetro.go.jp

Japanese Ministry of Finance: http://www.mof.go.jp/english/

Chapter 18

NORTH AMERICA

Contents

Objectives of the chapter

Within NAFTA (and CUSMA), the United States, Canada and Mexico constitute a thriving economic bloc. More than 33 per cent of all US trade exports go to Canada and Mexico; both those countries conduct well over 75 per cent of their international trade with the United States (see Tables 18.1, 18.2 and 18.3). Since market access to the United States is fairly open and already well documented, this chapter will focus on the other two members of NAFTA: Canada and Mexico. These countries are very different from the United States and have distinctive business practices.

Doing business in these countries requires just as much research and attention to institutional detail as doing business in the EU or Japan.

The specific objectives of this chapter are to:

1 *Examine* the nature of the Canadian and Mexican political and economic systems and their implications for business strategy.

2 *Review* the business environment with primary attention on the industrial, regulatory, banking and finance, and labour relations areas.

3 *Investigate* major economic opportunities that exist in Canada and Mexico and some of the ways of conducting business in these nations.

4 *Consider* specific institutional arrangements, namely, the United States–Canada Free Trade Agreement (FTA), the North American Free Trade Agreement (NAFTA), and the Canada–United States–Mexico Agreement (CUSMA), which play an important role in shaping opportunities and the business environment in North America.

ACTIVE LEARNING CASE

FTA, NAFTA AND CUSMA

The fortunes of the Canadian economy are fairly closely tied to the US economy. A strong US dollar puts pressure on the Canadian dollar (the 'loonie') and under the Trump administration this combined with trade tensions, specifically over steel and aluminium trade in 2018–19. But the country has benefited from many decades of trade agreements with the US and Mexico, through the FTA, NAFTA and more recently CUSMA.

The **United States–Canada Free Trade Agreement (FTA)** was designed to eliminate tariffs and most other trade barriers between the two countries.[1] Some of its specific provisions, to be implemented by 1998, were:

1. All tariffs on US and Canadian goods were to be eliminated.
2. Most import and export quotas were to be eliminated.
3. Use of product standards as a trade barrier were prohibited and national treatment of testing labs and certification bodies was established.
4. Many restrictions on agricultural products, wine and distilled spirits, auto parts and energy goods were sharply reduced, or eliminated.
5. The size of the government procurement markets that will be open to suppliers from the other country was slightly increased.
6. Travel by business visitors, investors, traders, professionals and executives transferred within a firm was facilitated.
7. The opportunity to invest in each other's country was facilitated and encouraged through the adoption of national treatment.
8. A binational commission to resolve disagreements that may arise from the enforcement of the FTA was established; it dealt with some 20 cases in the first three years of the agreement.

The **North American Free Trade Agreement (NAFTA)** came into effect in January 1994. Over the years, it has been the subject of debate and frequent misunderstanding. For example, in the 2008 campaign for the Democratic presidential nomination both Senator Hillary Clinton and Senator

Barack Obama pledged to renegotiate NAFTA to add environmental policies and to help labour adjustment. Yet, NAFTA was the first international trade agreement to incorporate both of these issues. NAFTA set up an environmental commission to monitor the impact of environmental regulations on trade and investment. NAFTA also incorporated labour adjustment programmes in the form of assistance for retraining and upgrading of individual worker skills.

In 2018, Canada, the United States and Mexico signed the Canada–United States–Mexico Agreement (CUSMA), on the margins of the G20 leaders' summit in Buenos Aires.[2] This revised, but mainly reinforced, many of the benefits that NAFTA created.

What then is the actual nature of NAFTA and what has been its impact? While NAFTA is a complex international agreement, it only has two basic principles. First, all tariffs on trade in manufactured goods are abolished. Second, the principle of national treatment is applied to foreign direct investment. Together these two basic principles serve to help open the internal markets of all three countries to greater amounts of trade and investment. In other words, regional economic integration is fostered. Indeed, recent data indicate that Canada and Mexico account for about one-third of all US trade (these countries are the largest trading partners for the United States, ahead of China, Japan and the EU; see Table 18.1). Both Canada and Mexico have over three-quarters of their trade with the United States (see Tables 18.2 and 18.3).

NAFTA, however, is not a pure free trade agreement, since many sectors are exempted from its provisions. For example, although tariffs have been abolished, the US textile and apparel sector is protected through a system of rules of origin. The latter serve to exclude garments assembled in Mexico from using textile fibres produced in Asia. In a similar manner, automobiles cannot be assembled in Mexico and sold in the United States and Canada unless they have most of their components produced in North America. Similarly, much of the US agriculture sector is still protected from Mexican competition. In the service sector (which now accounts for over 80 per cent of all jobs in the United States and Canada), well over half the sectors were exempted from the principle of national treatment. For example, excluded sectors include all aspects of: healthcare; education; public administration; transportation; and public utilities. This means that each country can enact discriminatory regulations to foster its indigenous firms and exclude foreign nationals from working in these exempted sectors.

Source: Bettmann/Getty Images

Table 18.1 Direction of US trade, 1999–2018

Country/region	Exports to								Imports from							
	1999		2008		2014		2018		1999		2008		2014		2018	
	US$bn	%	US$bn	%	US$bn	%	US$bn	%	US$bn	%	US$bn	%	US$bn	%	US$bn	%
Canada	162.95	23.59	260.91	20.07	312.42	19.27	298.9	17.96	198.82	18.96	339.71	15.68	347.8	14.8	318.48	12.61
Mexico	86.38	12.5	151.53	11.65	240.25	14.83	265.01	15.92	109.49	10.44	218.08	10.06	294.47	12.5	346.53	13.73
Japan	57.73	8.35	66.57	5.12	66.83	4.12	74.97	4.5	134	12.78	143.35	6.61	134	5.7	142.6	5.65
China (incl. Hong Kong)*	25.71	3.72	93.14	7.16	123.66	7.63	157.8	9.48	98.65	9.4	363.22	16.76	466.75	19.8	545.8	21.62
EU†	151.86	21.98	275.29	21.17	277.3	17.1	319.65	19.21	199.58	19.03	376.98	17.4	418.34	17.8	319.65	12.66
All others	206.04	29.83	452.53	34.81	600.01	37	547.90	32.92	307.86	29.36	724.64	33.45	686.31	29.2	851.67	33.73
Total	690.68	100	1300	100	1620.48	100	1664.23	100	1048.43	100	2166	100	2347.68	100	2524.73	100

*Data for China in 2014 exclude Hong Kong.

†EU data for 1999 are for EU15.

Source: Adapted from IMF, Direction of Trade Statistics Yearbook, 2000, 2009, 2014 and 2018.

Table 18.2 Direction of Canada's trade, 1999–2018

Country/region	Exports to								Imports from							
	1999		2008		2014		2018		1999		2008		2014		2018	
	US$bn	%	US$bn	%	US$bn	%	US$bn	%	US$bn	%	US$bn	%	US$bn	%	US$bn	%
United States	208.01	87.64	354.67	77.68	364.48	76.7	337.83	75.46	143.49	67	214.07	52.43	276.16	54.4	249.15	51%
EU*	10.43	4.39	34.23	7.5	35.05	7.3	33.27	7.43	21.52	10.05	50.93	12.47	57.52	11.3	59.73	12%
Japan	5.25	2.21	10.42	2.28	9.72	2	9.97	2.23	10.1	4.71	14.43	3.53	13.21	2.6	13.64	3%
Triad	223.69	94.25	399.33	87.46	409.25	86	381.07	85.12	175.12	81.77	279.44	68.44	346.89	68.4	322.52	66%
Mexico	1.02	0.43	5.49	1.2	4.96	1	6.33	1.41	6.26	2.92	16.73	4.09	28.59	5.6	29.92	6%
All others	12.61	5.31	51.71	11.32	60.42	12.7	60.29	13.47	32.77	15.3	112.07	27.45	131.54	25.9	133.03	27%
Total	237.33	100	456.54	100	474.62	100	447.69	100	214.16	100	408.25	100	507.03	100	485.47	100

*EU data for 1999 are for EU15.

Source: Adapted from IMF, Direction of Trade Statistics Yearbook, 2000, 2009, 2014 and 2018.

Table 18.3 Direction of Mexico's trade, 1999–2018

Country/ region	Exports to								Imports from							
	1999		2008		2014		2018		1999		2008		2014		2018	
	US$bn	%	US$bn	%	US$bn	%	US$bn	%	US$bn	%	US$bn	%	US$bn	%	US$bn	%
United States	120.39	88.27	233.52	80.15	318.36	80.1	358.22	79.5	105.26	74.14	151.33	49.03	214.81	48.8	228.77	46.49
Canada	2.39	1.75	7.1	2.43	10.71	2.6	14.07	3.12	2.94	2.07	9.44	3.05	11.05	2.5	11.42	2.32
North America*	122.78	90.02	240.62	82.59	329.08	82.8	372.29	82.63	108.21	76.22	160.77	52.09	225.86	51.3	240.19	48.81
EU†	5.19	3.81	17	5.83	19.99	5	25.39	5.64	14	9.86	38.33	12.42	47.05	10.6	56.1	11.4
Japan	0.77	0.56	2.04	0.7	2.61	0.6	3.85	0.85	5.08	3.58	16.28	5.27	19.3	4.3	19.28	3.92
All others	2.43	1.78	9.8	3.36	45.45	11.4	49.04	10.88	10.87	7.65	77.38	25.07	147.77	33.5	176.56	35.88
Total	136.39	100	291.34	100	397.13	100	450.57	100	141.97	100	308.6	100	439.97	100	492.13	100

*Excluding Mexico.

†EU data for 1999 are for EU15.

Source: Adapted from IMF, Direction of Trade Statistics Yearbook, 2000, 2009, 2014 and 2018.

In terms of environmental regulations, NAFTA was limited (under multilateral trade rules from the WTO) in its ability to enforce US and Canadian environmental standards upon Mexico. However, NAFTA aimed to harmonise environmental standards over time by requiring that Mexico set minimum environmental standards and improve its enforcement to match those of its neighbours within NAFTA. This process is monitored by a trilateral environmental commission headquartered in Montreal, Canada. Research on the environmental aspects of NAFTA by Rugman et al. (1999, 2005) showed that, as US and Canadian automobile suppliers and specialty chemical firms relocated to Mexico under NAFTA, these firms built new plants which incorporated the high environmental standards (ISO 1400) engineered into their production processes. Thus, environmental standards in Mexico have arguably improved specifically due to NAFTA. Furthermore, each country retains sovereignty over its environmental laws, although compensation can be sought by a foreign investor if a change in such laws results in unfair economic loss, as assessed by the trilateral environmental commission.

As a result of NAFTA there has been a large increase in trade and investment across North America. The region has become even more integrated. Intraregional trade flows have increased significantly over the treaty's first two decades, from around $290 billion in 1993 to more than $1.1 trillion by 2018. Cross-border investment and travel have also increased significantly. The United States now trades more in goods and services with Mexico and Canada than it does with Japan, South Korea, Brazil, Russia, India and China combined. Why has NAFTA been so successful,

enough to agree CUSMA, despite the President of the time, Trump, waging a trade war and increasing protectionist barriers?

From the viewpoint of the United States it gains more secure access to the natural resources of Canada and Mexico. In particular, Canada has agreed to continue supplies of oil and gas exports to the United States even in times of economic disruption (in legal terms, existing contractual arrangements will be guaranteed). While Mexico did not incorporate such energy provisions into its NAFTA agreement, it is clear that the United States now has more secure energy supplies from Mexico and internally than it does from the Persian Gulf.

The big gain for Canada and Mexico from NAFTA is better and more secure long-run access to the US market. What are the implications of this for Canadian and Mexican business? In Canada, a new set of Canadian businesses has emerged. These are successful competitors in the US market. These firms include Bombardier and Magna (see **International Business Strategy in Action: Magna International Inc.** in Chapter 11) and a set of large financial institutions including the Canadian banks. In Mexico, companies such as Cemex and Carso Global Telecom have become major players in the United States. Perhaps more important is that clusters of world-class businesses have developed in Toronto, Montreal, Calgary and Vancouver in Canada and in Monterrey in Mexico. In short, the business sectors in both Canada and Mexico are being upgraded and modernised, such that these countries are creating new jobs for skilled and educated workers across the integrated geographic space of North America.

Sources: https://international.gc.ca/trade-commerce/trade-agreements-accords-commerciaux/agr-acc/cusma-aceum/index.aspx?lang=eng; Mohammed Aly Sergie, 'NAFTA's economic impact', US Council on Foreign Relations (14 February 2014), http://www.cfr.org/trade/naftas-economic-impact/p15790; Alan M. Rugman (ed.), *Foreign Investment and NAFTA* (Columbia, SC: University of South Carolina Press, 1994); Alan M. Rugman, John Kirton, and Julie Soloway, *Environmental Regulations and Corporate Strategy: A NAFTA Perspective* (Oxford: Oxford University Press, 1999); Alan M. Rugman, 'North American intra-regional trade and foreign direct investment', in Alan Rugman (ed.), *Research in Global Strategic Management*, Vol. 10 of North American Economic and Financial Integration (Oxford: Elsevier, 2004); Alan M. Rugman, *The End of Globalization* (New York: Amacom, 2000, 2001); Alan M. Rugman, 'Continental integration and

foreign ownership of Canadian industry: a retrospective analysis', in Lorraine Eden and Wendy Dobson (eds.), *Governance, Multinationals and Growth* (Cheltenham: Edward Elgar, 2005); Alan M. Rugman, 'Regional multinationals and regional trade policy: the end of multilateralism', in Michele Fratianni, Paolo Savona, and John Kirton (eds.), *Corporate, Public and Global Governance* (Aldershot: Ashgate, 2007).

1. **How have NAFTA and CUSMA affected Canada?**
2. **Have NAFTA and CUSMA increased trade between the United States and Canada? Why is this?**
3. **How have NAFTA and CUSMA affected Mexico?**
4. **How have NAFTA and CUSMA affected the United States?**
5. **Do NAFTA or CUSMA include environmental laws?**

INTRODUCTION

In Chapter 10 we saw that governments and the various institutions through which they wield their powers are important external factors in the international business environment. We also used the diamond and double diamond frameworks to understand the trade and investment interdependencies across regions, with North America used as a central example. This chapter focuses on institutional factors in the North American market that must be considered when looking at the Canadian and Mexican markets. NAFTA and more recently CUSMA, have not abolished all trade barriers between the United States, Canada and Mexico. There are still major impediments to trade and investment. Furthermore, each of the partners retains its own trade laws. A legal mechanism to appeal trade decisions exists, but this is a compromise position. In contrast, EU member states cannot use trade laws against their partners. So, although NAFTA was a step towards trade liberalisation, business decisions should not assume that 'free trade' makes Canada and Mexico identical to the United States.

CANADA

With a land area of almost 3.85 million square miles (9.98 million km^2) Canada is second in size only to Russia. Divided into ten provinces and three territories (see Figure 18.1), Canada is so large that it encompasses six time zones. The French and British fought over the country, with control passing into British hands in 1763. Canada became a separate nation in 1867, although it did not fully repatriate its Constitution until 1982. Today it remains a leading member of the British Commonwealth.

Figure 18.1 **North America, 2017**

Source: http://data.worldbank.org/indicator/SP.POP.TOTL.

Canada's economy

Canada's 36 million people enjoy one of the highest standards of living in the world. Consumer tastes and disposable wealth are very similar to those in the United States. Gross domestic product (GDP) in 2017 was about $1.6 trillion.[3] The rate of economic growth has normally been in the 0 to 2 per cent range. Canada has typically had a positive balance of payments, thanks to its

food, energy and motor vehicle exports. Its primary trading partner is the United States (see Table 18.2).

Canada's economic growth historically has been based on the export of agricultural staples, especially grains, and on the production and export of natural resource products such as minerals, oil, gas and forest products. However, major secondary industries have also emerged; Canada now ranks as one of the major manufacturing nations in the world. The service industry is also expanding rapidly, especially financial services in Toronto. However, the country still faces a major productivity challenge. The USA has ten times the population of Canada and its economy is slightly less than ten times the size of Canada's, but Canadians are about 85 per cent less productive than the Americans.

Almost 80 per cent of manufacturing activity is located in Ontario and Quebec – including the entire motor vehicle industry, which is Canada's largest segment – while Calgary has become a major high-tech centre. Almost one-quarter of all Canada's exports (and imports) are in autos and auto-related products. The Canada–United States Automotive Products Trade Agreement (Autopact) has encouraged this two-way trade over the last 35 years, allowing free trade in autos assembled in either country, provided there was 50 per cent value added in Canada. Financial institutions and other business service industries are also concentrated in central Canada. The eastern and western areas of the country are more dependent on primary industries: fishing, forestry and mining in the east; agriculture, ore and mineral fuels in the west. The country's growth was helped by large inflows of foreign direct investment (FDI); today, a large proportion of the primary and secondary industries are foreign owned. Yet Canada is wealthy enough now, and its economy is sufficiently mature, to have substantial outward FDI, particularly in the United States.

The United States has more FDI in Canada than in any other country, including the UK. In 2012, it stood at about $326.5 billion and by 2017 it had grown to $391.2 billion, dominated by manufacturing, nonbank holding companies and finance and insurance. Canada's stock of FDI in the US was $453.1 billion in 2017, following a significant jump of 19 per cent from the previous year, dominated by manufacturing, finance and insurance, and wholesale trade.

We can see these relationships within individual industries. For example, many US airlines, including American, Delta and Northwest, fly to Canada, and Air Canada, among others, have US routes. So, part of the US international airline strategy involves competing with Canadian carriers that are vying for the US market.

✔ Active learning check

Review your answer to Active Learning Case question 1 and make any changes you like. Then compare your answer to the one below.

1 How have NAFTA and CUSMA affected Canada?

NAFTA and CUSMA have eliminated tariffs and make it easier for efficient Canadian firms to operate competitively in the United States. At the same time, they allow efficient US firms to ship their goods into Canada without paying any tariffs and, in the process, help drive down prices. So, NAFTA and CUSMA help the Canadian economy by encouraging efficiency, lowering prices and opening up new markets in the United States.

Differences in the business environment

Despite many similarities between the business environments of the United States and Canada, there are also some important differences.

Canada's industrial climate

The Canadian economy is characterised by private enterprise. However, some industries, such as broadcasting and public utilities, are government owned or subject to substantial government regulation. In the 1990s, the trend was towards privatisation and deregulation. The federal government was responsible for selling companies that the government felt were no longer essential to meet public policy goals. Firms that were privatised include Canadair, the de Havilland Aircraft Company, Canadian National Railway's trucking division, Fishery Products International and Air Canada (see **International Business Strategy in Action: Air Canada's bid for consolidation**).

INTERNATIONAL BUSINESS STRATEGY IN ACTION

Air Canada’s bid for consolidation

Founded in 1937 and headquartered in Montreal (Canada), Air Canada is the nation’s largest airline by both fleet size and passengers carried. With over 30,000 employees, the firm generated revenues of $13.41 billion (US$) in 2018. In 2019, the firm looked to expand its business through the acquisition of another Canadian airline and travel tour operator, Transat AT, who own Air Transat. The deal, estimated to cost Air Canada approximately $520 million and praised by many analysts, sent shares of both companies soaring. Transat AT flies to around 60 destinations in over 25 countries in the Americas and Europe. In 2018, Transat AT had revenues of $2.3 billion and employed around 5,000 people.

Air Canada announced that it was interested in purchasing all outstanding shares of Transat AT for $13 per share. This was rather generous, coming in at 23 per cent above Transat’s share price at the time. With this in mind, Transat AT agreed to a 30-day period of negotiations with Air Canada. The airline industry in Canada had already been witnessing change in 2019, as just before Air Canada’s intentions to acquire Transat AT surfaced, Toronto-based Onex Corp. revealed that it would acquire WestJet Airline for $3.5 billion.

Air Canada’s strategic acquisition of Transat AT was driven by the anticipated synergies of combining the assets and capabilities of both firms, connecting different parts of the travel industry value chain. Calin Rovinescu, Air Canada’s CEO, stated that the combination was a great opportunity for all parties. Rovinescu claimed that, in both companies, shareholders would benefit from increased returns, employees would benefit via increased job security and promotion prospects, and that the consumers would benefit from Air Canada’s enhanced ability to act as an industry leader post-acquisition. Following this, Transat AT were quick to reiterate that positivity, with Jean-Marc Eustache, the CEO of Transat AT, stating that it would be good to team up with a company that already knew the industry, and that the acquisition was the best prospect for maintaining and growing the business in the long run.

Although both parties seemed to be in favour of the proposed acquisition, the deal was complicated by three key factors. First, other firms were also interested in acquiring Transat AT.

Second, government approval was needed to get the deal through competition policy regulations. Third, it was difficult to know whether the firm's main shareholder would support the deal.

The driving force behind Air Canada's desire to acquire Transat AT was their ownership of Air Transat, which held approximately 20 per cent of the market for flights between Canada and Europe. This would provide Air Canada with a combined market share of 63 per cent (see Figure 18.2). In addition, Air Transat operated around 22 per cent of all flights between Canada and sun destinations such as Mexico, Jamaica, the Caribbean and Central America. Once again, a successful acquisition would see an increase in Air Canada's market share, boosting it to 46 per cent (see Figure 18.2). Acquiring Transat AT, and in turn Air Transat, would give Air Canada a dominant position in both markets; transatlantic flights between Canada and the UK, as well as sun routes. Air Transat's seasonal strategy at the time was proving successful (see Figure 18.3), with 85 per cent of total flights going to sun destinations in the winter, and 75 per cent of all flights going to transatlantic destinations in the summer. Because of the market dominance that would result from a successful take-over of Transat AT by Air Canada, Canada's Competition Bureau (CCB) took a strong interest. The CCB's main purpose was to ensure that takeovers do not create market monopolies, in turn disadvantaging consumers.

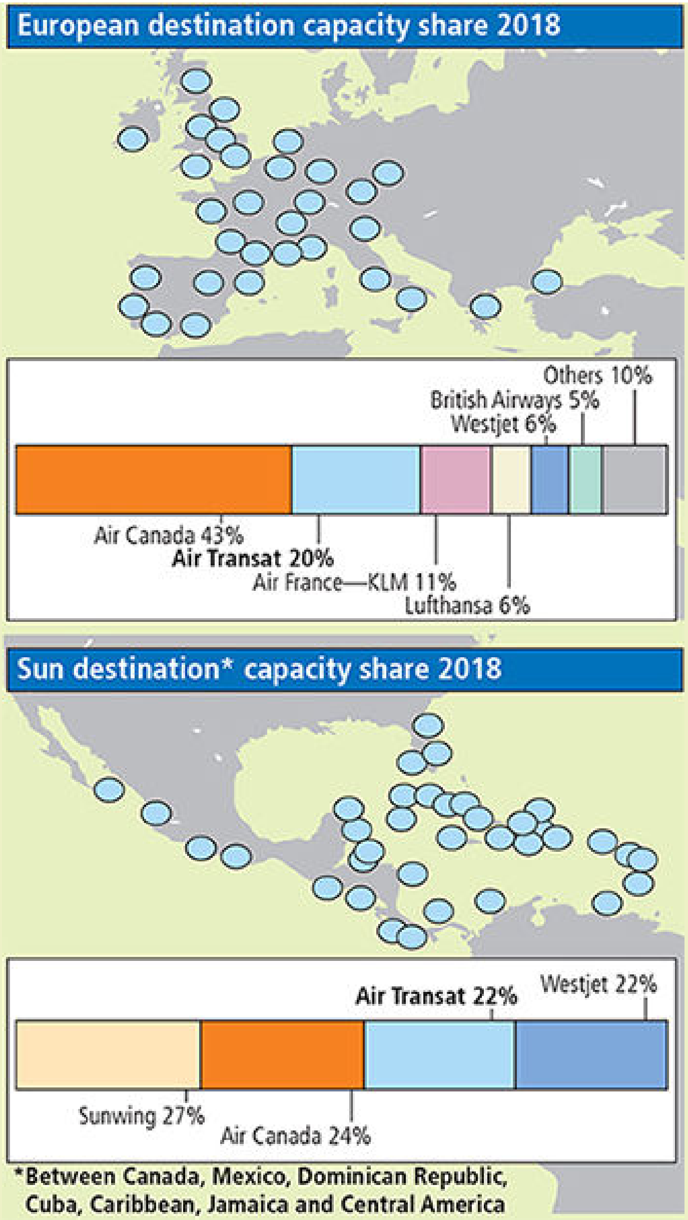

Figure 18.2 Airline market share between Canada and Europe and Canada and Sun destinations, 2018

Source: https://www.cbc.ca/news/business/air-canada-transat-1.5138180.

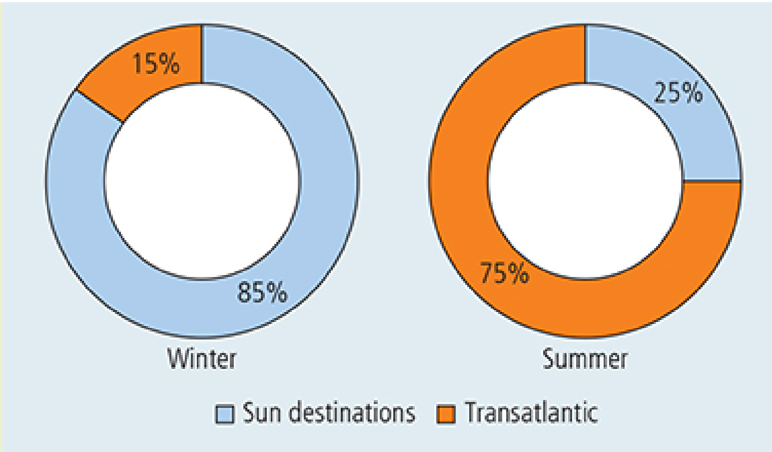

Figure 18.3 Air Transat's seasonal strategy

Source: https://www.cbc.ca/news/business/air-canada-transat-1.5138180.

The final key consideration of the proposed deal was the opinion of Transat AT's biggest single shareholder, Letko Brosseau and Associates, a Montreal-based investment firm which owned 6.5 million shares, equivalent to around 17 per cent of the company. Transat AT had a diversified portfolio, which included travel agency Air Transat. They were in the process of building 5,000 hotel rooms in some of their Caribbean destinations. So, a take-over by Air Canada may well create travel business synergies and yield high dividends for existing shareholders, but many of these other projects might not be continued if Air Canada looked to consolidate the business and focus on travel.

Although most mergers and acquisitions fail, in this case it did look like Air Canada had done its homework before starting the process. But key strategic questions remained about moving away from its core business, the airline market, and as with most acquisitions, operational scope would probably be squeezed. While the acquisition presented interesting opportunities for Air Canada to consolidate the market, acquisitions are a complex and resource-intensive endeavour.

At the time of writing this case study the acquisition of Transat AT by Air Canada was unresolved and subject to a great deal of debate and lobbying, for and against the deal. You can now find out what happened next!

Source: https://uk.news.yahoo.com/air-canada-in-exclusive-talks-to-buy-transat-in-520-million-deal-125836261.html; https://globalnews.ca/news/5271094/westjet-onex-business-class-international-

flights-rewards/ https://www.cbc.ca/news/business/air-canada-transat-1.5138180; Air Canada Annual Report 2018 Transat AT Annual Report 2018.

Small business is a major part of the economy and accounts for almost 80 per cent of all new employment in manufacturing. The service and retail trade industries are characterised by a large number of companies that vary in size; 79 per cent of Canadians work in service industries.

Canada's regulatory environment

Commerce and industry in Canada are regulated at every level of government: federal, provincial and municipal. Many of these regulations are similar to those in the United States.

Competition

Regulation of competition is under the jurisdiction of the federal Parliament. Legislation aims to eliminate restrictive trade policies, stimulate production and promote the international competitiveness of Canadian business. Although there are no price controls in Canada, there is regulation to review monopolies, acquisitions and mergers. The regulation of anti-competitive practices is handled under the **Competition Act**, which prohibits individuals and companies from practices that will substantially lessen or prevent competition in the marketplace. The Act outlaws bid rigging, price discrimination or conspiring to unduly lessen competition, and provides for regulation of acquisitions and mergers. If the purchase price is $400 million or more, the parties must refrain from completing the transaction for a time period ranging from 7 to 21 days. During this time, the government reviews the situation and decides whether the purchase will prevent or lessen competition (using international comparisons) and thus be uncompetitive in nature. A ruling is then made.

✔ Active learning check

Review your answer to Active Learning Case question 2 and make any changes you like. Then compare your answer to the one below.

2 Have NAFTA and CUSMA increased trade between the United States and Canada? Why is this?

The data show that US–Canada trade has increased as a result of NAFTA and CUSMA. Three reasons can be cited. First, the elimination of all tariffs encouraged exports. Second, both countries are more likely to produce those goods and services for which they have a competitive advantage and to buy the others from their neighbour. Third, as the economies of the two countries grow, so will the amount of trade as each begins to adapt operations to the desires of the other and starts to tap this market further.

Exports and imports

Export permits are required for the shipment of goods having strategic value, such as uranium. They are also required to implement the provisions of various international agreements into which Canada has entered. Import documentation is also required, as well as payment of a goods and sales tax (GST) or the federal part of the harmonised sales tax (HST), except for items specified as non-taxable importations. The GST, which went into effect on 1 January 1991, is a value-added tax. On imports, it is collected by Canadian Customs. GST (5 per cent) is payable on most goods at the time of importation. There is also Provincial rate (PST) which varies across the 13 provinces and is added to the national GST. In 2019, this was 9.9 per cent in Quebec, for example.

Francisation in Quebec

The Canadian federal government has a bilingual policy. But in the province of Quebec, French is the official language for business and education. All firms employing 50 or more people in Quebec must use French at all levels of the organisation. Other regulations related to the use of French in Quebec are that: (1) all product labels must be in French, and translations cannot be given greater prominence than the French portion; (2) company names and signs must be in French, but a version of the firm's name in another language may accompany the French version for use outside Quebec; and (3) all signs on the outside of stores must be in French only. Moreover, all education, health services and other services under provincial jurisdiction are delivered in French. Some exceptions to the French language and sign law policies accommodate the one-fifth of the Quebec population that speaks English. For example, McGill University and Concordia University can operate in English, and English signs can be displayed inside stores, provided they are smaller than French signs.

Banking and finance

Banks in Canada offer a full range of financial services. The five largest Canadian banks have extensive national branch networks and dominate the economy. These are: Royal Bank of Canada (RBC); Toronto-Dominion Bank (TD); Bank of Nova Scotia (Scotiabank); Bank of Montreal (BMO); and Canadian Imperial Bank of Commerce (CIBC). There are also many smaller (often foreign-owned) banks. All these banks respond to the actions of the central bank, the Bank of Canada, a federal government institution directly responsible for the nation's monetary policy, including (1) regulating credit and currency, (2) controlling and protecting the external value of the Canadian dollar (the 'loonie'), and (3) regulating the general level of production, trade, prices and employment, within the scope of monetary policy.

In carrying out its functions, the Bank of Canada buys and sells foreign exchange and sets the interest rate charged to commercial banks. These functions are similar to those carried out by the Federal Reserve in the United States, which helps monitor the US monetary system. The Bank of Canada is also responsible for issuing the country's notes and coins and for managing the federal debt. Canadian interest rates and its exchange rate closely follow those set in the United States, especially in relation to non-North American interest and exchange rates.

Banks operate within the confines of the Bank Act. There are two types: Schedule A and Schedule B. Schedule A banks are Canadian owned and no shareholder has more than 10 per cent of the voting stock. Schedule B banks are closely held Canadian-owned or foreign banks. These are allowed to carry on normal banking activities. However, foreign-owned banks cannot, as a group, own more than 16 per cent of the total domestic assets of the Canadian banking system. Subsidiaries of US banks are not subject to this restriction because of the US–Canada Free Trade Agreement. In addition, Canadian banks are allowed to operate across the country.

There is also a host of specialised financial institutions that provide limited services throughout the provinces. Examples include savings banks, cooperative credit unions, loan companies, mortgage companies and insurance companies. Investment bankers provide short-term funds to companies for acquisition or reorganisation purposes.

Canada has a few major stock exchanges: CNQ is Canada's newest stock exchange for trading the equity securities of emerging companies; ICE Futures Canada, incorporates the Winnipeg Commodity Exchange; the Montreal Exchange (Bourse de Montréal); NASDAQ Canada; NGX (Natural Gas Exchange); and the Toronto Stock Exchange (TSX). Toronto is the major exchange, accounting for most of the dollar trading volume. It is also the financial centre of the country.

Labour relations

Labour relations are governed by both federal and provincial labour legislation. The **Canada Labour Code** is the federal law that covers such matters as wages, employment practices, work safety and conciliation in the event of a labour dispute. Provincial governments have similar laws to cover employer–employee relations at the local level.

Unions

With the exception of farmers and white-collar workers, the workforce is heavily unionised. Approximately 30 per cent of the total labour force is in unions, compared to approximately 13 per cent in the United States. In some cases the workers are free to choose or reject union membership; in other cases they must become members in order to keep their jobs. The labour–management contract determines these conditions.

As in the United States, once a union has been certified to represent the workers, management must bargain in good faith. The result of such bargaining is a labour–management agreement that determines wage rates, fringe benefits, working conditions and management rights. Economic nationalism is a strong component of Canadian unionisation, and the unions have often been opponents of the FTA, NAFTA, CUSMA, and other economic and political relationships with the United States.

Working conditions

All provinces have legislated minimum wage rates that are periodically adjusted. However, in most sectors wages and salaries are similar to US levels. A national compulsory contributory pension plan provides retirement benefits to contributors, generally at the age of 65. This age limit varies, however, and there is growing pressure to relax mandatory retirement rules. In addition, many private pension plans are in effect. Other benefits include

group life insurance, medical insurance and subsidised food and housing. Most provincial legislation limits daily or weekly working hours, with mandatory overtime pay for hours worked in excess of these limits. The government also mandates minimum annual paid vacations in almost all industries, which is typically two weeks after a year of employment and up to three or four weeks after longer employment. There are also legislated holidays, which, depending on the city and the province, usually vary between 8 and 12 days.

All provinces prohibit employment discrimination on the basis of race, religion, national origin, colour, sex, age or marital status. There are also provisions for equal pay for equal work, which vary across provinces. They are designed to prevent gender bias in pay levels. For example, Ontario has specific 'pay equity' legislation that requires employers to remove gender bias in pay levels; salary adjustments were phased in, as long ago as 1990. Other provinces have subsequently followed suit.

Investments

The **Investment Canada Act (ICA)** came into effect in 1985, and is designed to create a welcome climate for foreign investment by significantly loosening previous restrictions. At the same time, however, some regulations still remain in effect. As noted earlier, investments in certain industries are restricted. For example, a licence to operate a broadcasting station can be granted only to a Canadian citizen or corporation whose stock is 80 per cent owned by Canadian citizens or Canadian-controlled corporations. Generally, non-residents cannot hold more than 25 per cent of the issued and outstanding shares of a chartered bank, a life insurance company, a sales finance firm, a loan company or a trust company. Nor can a single non-resident together with his or her associates hold more than 10 per cent of the issued and outstanding shares of these types of companies. Limits are much less stringent in the

securities industry, but the government must be kept apprised of such ownership.

Under the ICA, a non-Canadian wishing to acquire a Canadian firm must apply to the ICA for review and approval, if the assets are valued at more than $5 million or the business relates to Canada's cultural heritage or national identity. In the case of US firms buying Canadian operations, under the provisions of the Free Trade Agreement the ICA review takes place at the $150 million level. So the investment climate is much more conducive to US investors than to any others. When the ICA does conduct a review, a number of factors are considered in determining whether the investment will benefit Canada, including employment, technological benefits and product innovation.

In addition, numerous provincial statutes place restrictions on foreigners seeking to invest in particular industries or activities. For example, in most provinces individuals have to be Canadian residents for at least a year in order to be registered securities dealers. Similarly, foreigners who are registering ownership of land must disclose their citizenship. In Alberta, British Columbia, Manitoba, Ontario and Saskatchewan, a majority of the board of directors of corporations must be resident Canadians.

Canada's multinationals

It is useful to identify Canada's major companies against the background of global competition and triad power. Some larger Canadian firms like and Bombardier and Magna International (see **International Business Strategy in Action: Magna International Inc.** in Chapter 11) are well known in the United States.

Table 18.4 ranks the 25 largest Canadian-owned companies in decreasing order of size measured by their sales in 2016. Alongside finance and banking, energy, telecoms and other utilities sectors feature strongly. Canadian

offshoots of US firms Walmart and Costco are also listed. These firms also contribute to the performance of the country, creating jobs and wealth for Canadians. However, all foreign-owned firms must be examined in terms of their relationship to their parent companies. A high degree of autonomy, or development of world-class products in Canada, is necessary for a foreign-owned firm to provide sustained benefits to the country. Some energy firms, such as Imperial Oil (owned by Exxon Mobil), have a history of Canadian development. Others, such as Asea Brown Boveri (ABB), have a decentralised organisational structure with a large degree of local autonomy. These smaller but more autonomous Canadian firms (ABB is not on the list) have learned to survive within the global networks of their parent organisations, and their managers can help provide leadership to Canadians.

Table 18.4 The largest 25 Canadian-based firms, 2016 data

Rank	Name	Industry	Revenue (millions CAD$)	Assets (millions CAD$)	Profits (millions CAD$)
1	Manulife Financial Corp.	Life	53,337	720,681	2,929
2	Power Corp. of Canada	Life	50,750	422,903	1,134
3	Magna International Inc.	Vehicle	48,290	30,306	2,691
4	George Weston Ltd.	Food Sell	47,999	37,946	550
5	Royal Bank of Canada	Bank	46,326	1,180,258	10,405
6	Alimentation Couche-Tard Inc.	Food Sell	44,866	15,589	1,568
7	Toronto-Dominion Bank	Bank	40,952	1,176,967	8,821
8	Enbridge Inc.	Energy	34,560	85,832	2,069
9	Bank of Nova Scotia	Bank	34,266	896,266	7,117
10	Brookfield Asset Management Inc.	Real Est	33,886	214,646	2,188
11	Onex Corp.	Finance	29,843	57,632	(172)
12	Sun Life Financial Inc.	Life	28,573	258,238	2,581
13	Suncor Energy Inc.	Energy	26,822	88,702	434
14	Bank of Montreal	Bank	25,717	687,935	4,622
15	Imperial Oil Ltd.	Energy	25,049	41,654	2,165
16	Walmart Canada Corp.	Merchant	25,000	-	-
17	Empire Co. Ltd.	Food Sell	24,619	9,088	(2,131)
18	Costco Wholesale Canada Ltd.	Merchant	22,579	4,566	
19	BCE Inc.	Telecom	21,719	50,108	3,031
20	Bombardier Inc.	High-tech	21,649	30,655	(1,354)
21	Caisse de depot et placement du Quebec	Finance	21,132	290,817	20,109
22	Canadian Imperial Bank of Commerce	Bank	18,761	501,357	4,275
23	Direct Energy Marketing Ltd.	Utility	18,597	-	-
24	Agrium Inc.	Chemical	18,106	22,781	784
25	Mouvement des caisses Desjardins	Finance	16,978	258,367	1,696

Source: National Post FP500.

http://www.nationalpost.com/includes/blogs/2017/06/2fp500_2017/index.html.

Many large Canadian companies sell approximately 50 per cent of their output abroad. But there is a great deal of variability in terms of their level of multinationality – or dependence on the domestic market vs. international markets. This demonstrates the tremendous attraction of foreign markets for larger companies in a relatively small market like Canada's, providing further

evidence that access to a triad market (in this case, the United States) is critical for success in a global market.

Business opportunities in Canada

Multilateral agreement on investment (MAI)

Canada will benefit from any type of multilateral agreement on investment. An attempt to negotiate an MAI was made in Paris at the Organization for Economic Cooperation and Development (OECD) over the 1995 to 1998 period. The draft MAI was based on the lines of NAFTA. United Nations, UNCTAD Ministers may take up the need for an MAI.

An MAI includes the principle of national treatment: equal access for foreign investors to the host country's market (but according to host-country rules). A number of sectors are exempted from the national treatment principle. In the same spirit of the FTA, NAFTA and CUSMA, Canada insists on exemptions on healthcare, education, social services, cultural industries and transportation. All regulations on investment are identified, as are all exemptions to the principle of national treatment. Additionally, dispute-settlement mechanisms are put in place to allow individual investors (and companies) to appeal against government regulations and bureaucratic controls.

The need for an MAI arises because foreign investment has become an important part of the global economy. Today, the majority of international business is not done by traded goods but through services and investments. More than 75 per cent of North Americans work in the service sector, with less than 25 per cent in manufacturing. So the new agenda for international agreements is to negotiate rules for trade in services and investment.

Most of Canada's outward stock of FDI is in the United States, with which it already has national treatment through the abovementioned trade

agreements. Thus, its exporting businesses would prefer an MAI with transparent rules.

Marketing in Canada

Companies doing business in Canada need to know the distribution practices and advertising and promotion channels. In many cases, these are similar to those in other countries, but there are some important differences.

Distribution practices

Despite the country's vast size, sales to Canadian industries are characterised by short marketing channels with direct producer-to-user distribution. Many industries are dominated by a few large-scale enterprises that are highly concentrated geographically. It is not unusual for 90 per cent of prospective customers of an industrial product to be located in or near two or three cities.

The consumer goods market is more diffused than the industrial market, and the use of marketing intermediaries is often necessary. In many cases, complete coverage of the consumer market requires representation in a number of commercial centres across the country. Firms having only one representative or distribution point typically choose Toronto. If the country is divided into two major markets, the other is often Calgary or Vancouver. If the market is divided into three areas, distributors are frequently put in Montreal, Ontario and Vancouver.

Direct selling is another growing area. This includes the sale of goods from manufacturing premises by mail, home delivery, personal selling and other non-retail channels. Social media has also driven online sales, to around $30 billion in 2018, by one estimate. However, there are concerns that over 50 per cent of online consumer sales are from international firms, rather than domestic suppliers.

Wholesale and retail trade are also important forms of distribution. Because of the wide dispersion of customers, the physical distribution of goods is costly. Retail trade accounted for more than $375 billion in sales in 2018, down from almost $400 billion in 2011.[4] Retailing employed 11.5 per cent of the workforce. Department stores and supermarkets constitute a large percentage of retail sales. However, as in the United States, they are facing increased competition from online retailers, discount stores, showroom retailing and other forms of self-service retailing. There are also specialised markets for recreation and leisure equipment and associated services, as well as a growing demand for consumer durables. These trends are likely to continue well into the future.

Exporting

One of the most popular ways of doing business in Canada is through exports. As noted earlier, Canada is the United States' largest foreign market. Tables 18.1 and 18.2 show the mutual trade interdependence. 18 per cent of US exports go to Canada and only slightly more (19.2 per cent) go to the whole of the EU. Almost the same level of imports into the US come from Canada and the EU; they each account for 12.6 per cent. Canada, however, is a much smaller economy than the combined EU block.

Franchising

Canada is the dominant foreign market for US franchisers and the second-largest franchise market industry in the world, after the US. There are about 1,200 franchise companies operating around 76,000 franchised outlets in Canada and 4,300 new outlets open each year. Almost 45 per cent of retail sales are through franchise operations and in the restaurant sector they account for 35 per cent of all sales. So, there is a great deal of opportunity for those who want to do business in Canada via the franchise route.

Additionally, in recent years Canadian banks have become more responsive to the needs of franchised operations. Chartered banks now offer various loans and repayment plans for franchises. In some cases they also offer payroll and cash management services. So there is considerable opportunity in international franchise operations in Canada.

MEXICO

With a land area of approximately 76,000 square miles (1.9 million km^2) Mexico is equal in size to almost 25 per cent of the contiguous United States. It is the second largest nation in Latin America and has a population of over 129 million. The country is a federal democratic republic divided into 31 states and the Federal District (Mexico City). Although it endured political turmoil early in the twentieth century and subsequent drug wars in the twenty-first century, the government has been stable since World War II. Mexico is a nation where affluence, poverty, natural splendour and urban blight rub shoulders.

Mexico's economy

Mexico's economy is currently in a state of flux, brought on by new economic relations with the United States. Today Mexico has one of the strongest economy in Latin America. Historically strengthened by economic policies since the days of Carlos Salinas, marked by liberalisation rules regarding foreign investment and privatisation. These changes have dramatically improved the economy. GDP growth has recently stabilised at 2–3 per cent and unemployment is remarkably low by historical standards at about 3.5 per cent.[5] The country has also vigorously promoted exports, especially to the United States, which now counts on Mexico for a large proportion of all its imported fruit and vegetables. The *maquiladora* industry (see Chapter 10) is another growing source of economic strength for the country.[6] At the same time, Mexico has become a major region for international investment. In 2017 Mexico attracted 562 investment projects and a total of over $30 billion of inward FDI (much higher than Brazil, for example).[7]

MNE investment

The climate for foreign investment in Mexico has grown increasingly favourable in recent years. Although there were strict controls on foreign investment in the past, deregulation and a series of privatisations have opened up the economy, particularly to US firms. As a result, an increasing number of MNEs are investing in Mexico. Automobile investments have grown particularly strongly as Nissan and Volkswagen use the country as an export base for both the United States and Japan. Retailers like Sears, Roebuck and Walmart also have significant investments in Mexico.

Another reason for increased FDI has been the changes in investment laws that now permit foreigners to hold major equity positions. In the past, foreign ownership in auto parts companies had been limited to 40 per cent of equity, but a new decree now sharply reduces the number of firms subject to this law by creating exemptions based on percentages of export sales and sales to individuals. Today, most of the economy is open to full foreign ownership.

Labour

Labour is relatively plentiful and inexpensive. However, MNEs report a serious shortage of skilled labour and managerial personnel, particularly at the middle and upper levels of the organisation, and despite numerous engineers. Worker absenteeism in recent years has declined, but turnover remains a serious problem, even in the *maquiladora* sector.

Approximately 50 per cent of the total workforce is unionised. In industrial operations with more than 25 workers, about 90 per cent of the workforce is in unions. Union control over the members has strengthened in recent years and CTM (the Confederation of Mexican Workers, or Confederación de Trabajadores Mexicanos) oversees most of them, with around 11,000 labour unions as members.[8]

There is a long-standing and multi-tier minimum wage structure in Mexico, with an average wage of between US$4.50–$5.0. There is a zoning approach, with Mexico City and surrounding towns being at the top due to the high costs of living. Government regulations require that at least 90 per cent of a firm's skilled and unskilled workers be Mexican nationals, and employers must favour Mexicans over foreigners and union personnel over non-union personnel. On the other hand, these regulations are unlikely to limit investment by MNEs since the government permits hiring exceptions.

Mexico, NAFTA and CUSMA

In conjunction with their privatisation policies, Mexico sought to motivate business through increased exposure to international competitive forces and access to the dynamic US market. To this end, the government opened negotiations with the US and Canadian governments in Toronto on 12 June 1991, to create NAFTA. This marked the first time that a less developed country had entered into an agreement with two wealthy countries to create a free trade area. NAFTA went into effect in 1994, replaced/updated by CUSMA in 2018, and has had a major impact on Mexico's trade and investment.

Trade in several sectors has experienced considerable growth. In the textile and apparel sectors, quotas on Mexican products were phased out and customs duties on all textile and apparel products were eliminated. For automotive products, Mexico immediately reduced its tariffs on cars and light trucks by 50 per cent and pledged to eliminate the remaining duties over ten years. In agriculture, tariff restrictions were lifted on a broad range of goods when NAFTA went into effect.

Mexico's investment climate has also been affected by NAFTA. In the automotive sector, all investment restrictions were eliminated. In transportation, Mexico allowed 49 per cent ownership of cars and trucking

companies three years after NAFTA went into effect, 51 per cent after 10 years, and 100 per cent after 10 years. The Mexican finance and insurance sectors have also been liberalised. All these changes have opened up Mexico even more to FDI and, in turn, led to the growth of the Mexican economy and two-way flows of trade and investment with the United States.

As with the US–Canada FTA, binational panels play an important role in resolving trade disputes. Under NAFTA, panels continue to contribute towards trade disputes resolution and now also investment matters. Where investments are concerned, complainants may also take their cases to binding investor–state arbitration.

Regional trade agreements

Other developments involving Mexico as a leader in the movement towards free trade and privatisation have included the efforts to create and sustain regional trade agreements based on NAFTA. One of the major regional integration efforts has been the creation of the **Latin American Integration Association (LAIA, or ALADI**, its initials in Spanish), was created in 1980 to promote the economic and social development of the region, with the long-term aim of creating a common Latin American market. Currently, its members are Argentina, Bolivia, Brazil, Chile, Colombia, Cuba, Ecuador, Mexico, Panama, Paraguay, Peru, Uruguay and Venezuela. Nicaragua is in the process of joining. This group of countries covers an area of 20 million km^2 (nearly five times greater than the area of the 28 countries that comprise the European Union), about 530 million inhabitants and a GDP above US$ 5 trillion.[9]

At times in the past, sub-regional groups, such **Mercosur** in the southern cone, Argentina, Brazil, Paraguay and Uruguay, have slowed the progress of LAIA/ALADI. Similarly, the **Andean common market (Ancom)**, a sub-regional free trade compact designed to promote economic and social

integration and cooperation between Bolivia, Colombia, Ecuador, Peru and Venezuela was seen by some as a diversion from a pan-Latin American union.

The United States is aware of the need for reducing, and then eliminating, trade barriers in the Americas if it hopes to establish a viable world market that can compete against the European Union and the Asia-Pacific countries. The idea is also appealing to Latin American countries that see the opportunities associated with linking into the North American diamond and profiting from the economic growth it creates. This development will bring about a Western hemisphere trading bloc and may well become a reality in the early twenty-first century.

Doing business in Mexico

A number of strategic approaches are being used to conduct business in Mexico. (See the case **International Business Strategy in Action: Mexico's tomatoes**.) Two primary reasons for the success of these approaches are the high quality of the workforce and the dramatic improvement in the economy over the last two decades. MNEs operating in Mexico report that the quality of the workforce is excellent. For example, senior-level executives at firms such as Caterpillar, Ford, General Electric, IBM and Procter & Gamble all report that their Mexican workforces produce high-quality output. Moreover, a Massachusetts Institute of Technology study has named Ford's Mercury Tracer plant in Hermosillo the highest-quality assembly plant in the world. The head of IBM Mexico has stated that 'for every dollar you pay a Mexican engineer, you get more from him or her than you'd get in other societies around the world'.

At the same time, the market for goods and services is growing rapidly. Many MNEs admit that they are not in Mexico because of the low wage rates but because of rapidly growing demand. Despite a high inflation rate and loss of purchasing power, people want to buy consumer goods and live more like

their neighbours to the north. Mexicans are also expressing an interest in high-quality merchandise, with the result that companies are now reducing their reliance on agents and dealers and are instead opening sales subsidiaries and warehouses to provide direct technical assistance. A good example is Toyota, which started a plant in 2005 to produce vans for the US market, but later in the year responded to Mexico's growing demand for vans by producing for the domestic market. With a burgeoning population of 106 million and an economy that is growing even faster, Mexico promises to be a major target area for MNEs in the future. At the same time, these developments help Mexico link itself to the triad via the United States.

INTERNATIONAL BUSINESS STRATEGY IN ACTION

Mexico’s tomatoes

In 2018–19, much of the world’s attention was focused on the US and China trade-war. But the protectionist approach of the Trump administration was felt much more broadly, including Mexico, where a series of tariffs were announced, including a new tax on imports of fresh tomatoes. This move was politically motivated, triggered by increasing complaints from Florida’s tomato farmers. In the past Florida dominated the American market for tomatoes sold in the winter and spring, but over the last 20 years American famers had slowly lost market share to Mexico.

After representatives from both countries failed to reach a trade deal, in May 2019, the US formally announced a tariff on Mexico’s tomato industry, which was worth around $2 billion. The tariff was set at 17.5 per cent and Luz María de la Mora, Mexico’s undersecretary of foreign trade in 2019, went on record to say that this was ‘very disappointing’ as it would dent Mexico’s trade balance by around $350 million every year. Mexico was the largest exporter of tomatoes in the world at the time and faced continuous political pressure from Florida’s tomato industry. This is because Florida’s tomato farmers were closely connected with Republican politicians, and securing votes was particularly important given Florida’s position as a swing state.

At the start of 2019, the US also looked at reopening an antidumping investigation against Mexico. Reportedly, this initiative had been on hold since 1996 under a succession of ‘so-called’ suspension agreements. In 1996, when the NAFTA had been in effect for two years, removing tariffs and increasing imports, the US decided to set a minimum price on tomatoes from Mexico and issued an antidumping investigation.

Since then, the dust has never really settled between the two nations as over the years the US has continually set a number of price restrictions against the neighbouring country. Price restrictions in 2013 increased the floor import prices, which fluctuated depending on seasons by just over 40 per cent. Adjusting prices seasonally was part of a series of American attempts to give the Florida tomato industry an edge, when they were in season. However, disappointingly for the US, a number of studies found that these forms of protection actually did little to help the reduction in US imports or boost domestic production. For instance, when the US increased its seasonal protection measures

against Mexico, Mexico simply exported more tomatoes to Canada, and because the US in turn struggled to produce enough tomatoes to satisfy its domestic demand, Canada then increased their exports to the US.

Trade tensions between the two nations have caused fears in the past that there will be a US border shutdown and this impacted all of the fruit and vegetable industry in 2019. The price of Mexican Hass avocados, for example, increased by approximately 33 per cent in just one day in April 2019, the fruit's largest one-day price rise in the last 10 years. Oscar Woltman, the President of the Mexican Association of Protected Horticulture, stated that the reason why Mexico has not made a trade deal with the US is that Mexico would rather pay tariffs and defend their own rights, as opposed to making a reluctant agreement with the US, which could have long-run repercussions on Mexico's tomato industry.

But around 90 per cent of tomatoes imported into the US are from Mexico and 50 per cent of all consumed tomatoes in the US are from Mexico. This high dependency on Mexico inevitably means that any tariffs will have a sizeable impact on the price of tomatoes in the US. Domestic consumers eventually see costs rise which governments increase tariff barriers. Research from Arizona State University has speculated that tomato prices could increase by 40–85 per cent because of reduced supply from Mexico.

More open trade tends to drive down prices and this can increase consumption of particular products. Four decades ago, on average, US consumers purchased around 5.5kg of tomatoes per year per person, however, with increased supply from Mexico, this almost doubled to 10kg by 2017. Moreover, in 2015 the amount of tomatoes imported from Mexico was more than three times as large as Florida production and in the face of this growth it is unlikely that US farmers will ever be able to satisfy its domestic demands.

During the Trump administration in 2018, the US issued a set of tariffs on steel, washing machines and solar panels (see the **Active Learning Case: The US–China trade war: battle of the giants** in Chapter 6) in order to protect these domestic industries. However, these forms of protection have resulted in the US being worse off in many cases. Tomatoes are no different and although Florida's growers may have felt like they had an ally in the White House, the full consequences of protectionism inevitably end up being economically and politically damaging.

Sources: https://www.ft.com/content/bc808a1e-7082-11e9-bf5c-6eeb837566c5; https://www.npr.org/sections/thesalt/2019/05/07/721172201/food-fight-trump-administration-levels-tariffs-on-mexican-tomatoes?t=1558111810074; https://observer.com/2018/08/us-mexico-tomato-trade-nafta-talk/; https://www.newsweek.com/new-tomato-tariffs-which-foods-could-become-pricier-after-commerce-1421458; https://eu.usatoday.com/story/money/food/2019/05/07/mexico-tomato-tariff-u-s-tomato-prices-expected-increase/1135358001/.

✔ Active learning check

Review your answer to Active Learning Case question 3 and make any changes you like. Then compare your answer to the one below.

3 How have NAFTA and CUSMA affected Mexico?

The elimination of tariffs under NAFTA and CUSMA has tied Mexico's economic and social development into the North American regional triad. The country has developed a growing consumer market as the middle and upper classes in the country have increased their purchasing power and under NAFTA and CUSMA the US and Canada have benefited from having preferential access to this market. Mexican firms have also benefited from access to US and Canadian consumers and corporate buyers, creating large-scale and complex supply chains across North America. It could be argued, however, that Mexico is economically over-dependent on the North, relative to South America and this creates a political dependency in which Mexico is the weaker partner.

Mexico and the double diamond

Chapter 10 used North America as the central example to explain the Double-Diamond framework. It sets out why maintaining economic growth requires continually developing international competitive strength and for Mexico this is partly through linking to the US market. In particular, MNEs must view this market not just as a source for export but also as part of the home market. Specifically, this requires:

1 Developing innovative new products and services that simultaneously meet the needs of US and Mexican customers, with the recognition that close relationships with demanding US customers should set the pace and style of product development.

2 Drawing on the support industries and infrastructure of both the US and Mexican diamonds, realising that the US diamond is more likely to possess deeper and more efficient markets for such industries.
3 Making free and full use of the physical and human resources in both countries.[10]

To do this, Mexico is relying heavily on a series of strategic clusters. The six major ones, in order of importance, are petroleum/chemicals, automotive, housing and household, materials and metals, food and beverage, and semiconductors and computers. The two that are most internationally competitive and provide the best insights into how the Mexican double diamond is used are the petroleum and automotive clusters.

Petroleum cluster

Mexico's petroleum industry accounted for about 14 per cent of all exports in 2014 but declined to less than half of this by 2018. But the country still has the third largest proven oil reserves after Venezuela and the United States and remains one of the world's largest producers. The largest firm is state-owned Petróleos Mexicanos (Pemex), which is one of the world's largest companies. In 2013, Pemex had total assets of over $416 billion, including pipelines, refineries, tankers, aircraft and rail cars. This huge asset base helps explain why Mexico is a net exporter of energy, principally oil, natural gas, hydraulic power, nuclear and geothermal power, and coal.

However, oil production in Mexico reached a long-term low in 2019 and Pemex suffered $7.6 billion losses in 2018, following over $14 billion losses in 2017. This was a major concern because of the sheer size of the firm and the impact on government debt and public sector budgets. Oil exploration around this time did reveal that the Mexican Gulf of Mexico is more prolific in oil reserves than the US Gulf of Mexico.

The country also has strong petroleum-related industries and infrastructure. These are important components of industry clusters in the diamond framework. At present, over 150 firms operate several hundred basic and secondary petrochemical plants throughout the country and employing over 110,000 people. Domestic demand for oil-related products in Mexico has also risen sharply, forcing Pemex to become considerably more productive.

The export market for this oil was stronger in the past, particularly because of the US demand levels and dependence on foreign producers. This has changed over the past decade, with the US producing more of its own supply. But US oil firms, with their own clusters of energy technology companies, are looking for exploration opportunities outside the country and Mexico is likely to prove a very attractive location. Joint ventures between Mexican firms and major US companies such as Exxon Mobil, Valero and Chevron, to develop parts of the Gulf of Mexico will help drive up the competitiveness of both clusters. There are opportunities to improve efficiencies through various methods: (1) liberalising exploration programmes by allowing more efficient foreign drilling contractors to carry out turnkey operations; (2) reducing the cost base by working with the unions to rationalise jobs that are not required; (3) using foreign technologies in areas where Mexican expertise is lacking; (4) allowing greater participation of foreign firms in producing petrochemicals to expand capacity and competitiveness of commodity products to meet domestic and export demand; (5) using foreign MNEs to bring in technology to produce advanced petrochemicals for use in the US market; and (6) developing alternative, cleaner-burning fuels, such as natural gas, to reduce reliance on US imports and comply with international environmental standards. Thus, Mexico’s economic progress will be closely linked to the US diamond.

Automotive cluster

The global auto industry has undergone worldwide restructuring. In the process, Mexico has emerged as a major car and truck producer. Rapid growth from the late-1980s led to total unit production in 2002 of 2 million. There were subsequent declines, particularly in 2009 when total unit production fell 28 per cent compared to 2008 due to the world financial crisis leading to fall in exports. It has never reached those levels of production, but is the seventh-largest producer in the world after India at number 6 and the industry employs almost one million people.

The industry accounts for 15 per cent of all exports and 70 per cent of all Mexican-built cars are exported to the United States, down from 85 per cent about a decade ago. It is second only to Canada, which is the top automotive exporter to the US. In the past Mexico saw a surge of inward investment from the major US manufacturers setting up production in the country. Japanese and European firms also invested to take advantage of the low-cost labour, low capital cost, proximity to the world's largest auto market, growth of domestic demand and accessibility to related support industries. But more recently these firms and the big three from the US, Ford, GM and Fiat Chrysler, have been moving operations to other parts of the world, particularly China.

Mexico still has a strong, rich resource base supporting its automotive cluster as well as an abundance of young, skilled, adaptable labour. Foreign auto firms are finding that these workers are particularly effective after they have been trained in total quality management, just-in-time inventory, and related concepts. In addition, unions in Mexico are much more cooperative with management than their counterparts to the north. As a result, this resource base is now producing some of the highest quality cars and trucks in North America.

There are also strong supporting industries and a well-developed infrastructure in the automotive cluster. The auto parts industry, which is the

main supply chain, also employs a large number of workers and produces for both the domestic and export markets. Many of them are a result of FDI by US-based auto part firms. For example, GM has component plants in the country as well as financial participation with Mexican auto part companies. Ford has similar arrangements, as do Volkswagen, Nissan and a host of other foreign firms.

While the boom of foreign investment in auto parts initially displaced inefficient local parts producers, a handful of efficiently run local companies have emerged to become multinational producers. For instance, Mexico's Nemak is a top Tier 1 supplier with almost 40 production plants across 16 countries employing 21,000 people. It is a subsidiary of Mexican conglomerate, Alfa, with Ford holding a minority of shares.

NAFTA, CUSMA and the trade position taken by the US government as it seeks to change the rules of regional trade are critically important to the future of the Mexican automotive industry. Its major advantage lies in its proximity and accessibility to the largest auto market in the world and US protectionism is now threatening to raise import barriers, reducing this advantage considerably.

Active learning check

Review your answer to Active Learning Case question 4 and make any changes you like. Then compare your answer to the one below.

4 How have NAFTA and CUSMA affected the United States?

Trade deals like NAFTA and CUSMA lead to increased regional trade, for three reasons. First, the elimination of all tariffs will encourage exports. Second, all three countries are more likely to specialise in producing those goods and services for which they have a competitive advantage and, in turn, buy the others from their neighbours. Third, as the economies of the member countries grow, so will the amount of trade as each begins to adapt operations to the desires of the other and starts to tap this market. Furthermore, the United States has more secure access to a variety of energy sources and cheaper imports of automobiles from Canada and Mexico. This reduces prices for both firms and end-consumers and improves the competitiveness of the US economy.

The market potential of the automotive cluster is extremely high. Some problems, however, will have to be dealt with if the country is to continue increasing its competitiveness. Foremost among these is the need for greater technology. One major reason why Mexican autos are cost efficient is the lack of high automation and robotics. It is unlikely that this trend can continue, because labour prices are rising.

Overall, Mexico's economic future is closely linked to that of the United States and Canada. When analysed in terms of Porter's diamond, some of the country's strategic clusters have already developed worldwide competitive strength. Mexico is likely to begin making major inroads into other areas, including creative industries and services, as it develops favourable factor conditions, related and supporting industries, demand conditions, and the structure and rivalry of the firms. As a result, Mexico will find that it can link

its diamond framework with that of the United States and become a worldwide competitor in still other areas in the process. Porter’s diamond framework will prove to be a useful paradigm.

Active learning check

Review your answer to Active Learning Case question 5 and make any changes you like. Then compare your answer with the one below.

5 Do NAFTA or CUSMA include environmental laws?

There are environmental laws in NAFTA and even more under CUSMA, but these are still up for debate. There are issues of sovereignty. Should an international agreement set the standard for environmental laws or should the individual governments make their own laws to be responsive to their national needs? Although an environmental chapter was included in NAFTA, there is a growing concern among NGOs that environmental laws could be used as a non-tariff barrier to trade, keeping out some goods from the rich US market. Both the United States and Canada advocate the use of clean technology in NAFTA and pressing for higher environmental standards and processes in Mexico.

KEY POINTS

1 The North American triad is made up of Canada, the largest trading partner of the United States, and Mexico. The North American Free Trade Agreement (NAFTA) and more recently the Canada–United States–Mexico Agreement (CUSMA), recognise the high degree of trade between the countries and reduce the barriers to trade within this block.

2 Canadian financial institutions are similar to those in the United States, as are labour relations practices. However, a much larger percentage of Canadian employees are unionised, and the unions have been major opponents of trade agreements.

3 NAFTA and CUSMA are unlikely to ever eliminate all trade barriers between the three countries, and these increased under the Trump administration. But foreign investment across the borders is actively encouraged.

4 The approaches to doing business in Canada are similar to those in the United States, with some important regulatory differences. The chapter identified and discussed both.

5 Mexico has one of the strongest economies in Latin America and close business ties to the United States, as reflected by imports, exports and US FDI.

6 We may be past the peak years of cross-investment and trade between the US and Mexico. In the past, the *maquiladora* industry helped Mexico link its economy to that of the United States and strong petrochemical and automotive clusters were the focus of a high level of business interdependence. These have declined a little as other, particularly Asian countries have become preferred investment locations, but proximity

alone points to long-term trade and FDI connections between these countries.

Key terms

- **United States–Canada Free Trade Agreement (FTA)**
- **North American Free Trade Agreement (NAFTA)**
- **Competition Act**
- **Canada Labour Code**
- **Investment Canada Act (ICA)**
- **Latin American Integration Association (LAIA or ALADI in Spanish)**
- **Mercosur**
- **Andean common market (Ancom)**

REVIEW AND DISCUSSION QUESTIONS

1. How high is the Canadian standard of living? Of what value is this information to a company interested in doing business in Canada?
2. Is the Competition Act of any concern to US firms, given that the FTA has eliminated most trade restrictions? Explain.
3. What do companies seeking to set up businesses in Canada need to know about labour relations in that country? Identify and discuss three areas of importance.
4. What are the most important provisions of the Free Trade Agreement and how do they affect US firms doing business in Canada?
5. Are there any restrictions on foreign investments in Canada? Identify and describe two of them.
6. What should a firm seeking to enter the Canadian market know about marketing practices there? Identify and describe three practices.
7. How good are franchise opportunities in Canada? Explain.
8. Why is Mexico doing so well economically? Identify two developments that have been particularly helpful in bringing this about.
9. What is the purpose of the LAIA? Of what value is the organisation to its members?
10. How is Mexico using its petroleum cluster to link itself to the North American triad?
11. How is Mexico using its automotive cluster to link itself to the North American triad?
12. Why are these linkages to the North American triad likely to be economically advantageous to Mexico? Cite two reasons.

REAL CASE

Jumex of Mexico

Founded in 1961, Group Jumex is the largest producer of juices and fruit nectars in Mexico. As of 2017, the country has a population of approximately 130 million people and a hot climate that provides a favourable environment in which Jumex can grow. And grow it has.

Mexico offered other nurturing characteristics to the emerging company in the form of natural resources and market pressures. For one, Jumex has access to an incredible variety of tropical fruits from which it can develop new products. Indeed, the firm offers tamarind, guanábana and guava nectars as well as the more commonly known mango, peach, pear and apple.

Tropical fruits are readily available everywhere at a relatively low price, making the blending of juices in customers' homes extremely easy. Juice stands, in which the juice is made on site, are abundant throughout the country. Quality is paramount. Jumex cannot sell products with very little fruit content to Mexicans.

Jumex competes with other domestic producers at home for the juice and nectar market. It also competes with soft drink makers, including Coca-Cola and PepsiCo, for the beverage market. However, Mexican consumers have recently improved the lot of the juice makers, as carbonated drinks are increasingly considered unhealthy.

Competition has made Jumex into an aggressive marketer. The firm uses all types of distribution systems to maximise market share. It works with national wholesalers, regional wholesalers, supermarkets and small convenience stores to establish a price system that allows them to benefit from selling its products.

Mobile communication was provided to the sales team so that orders could be processed immediately, no matter how far away the distribution centre was. This is very important because of the remoteness of many Mexican communities. Prior to this, a salesperson could take two weeks before returning with paperwork to put in an order. Supermarket computerised distribution systems are now integrated with that of Jumex so that their shelves can be stocked as needed.

While most firms have shifted to aluminium, Jumex has maintained the traditional tin can and created a distinct shape that stands out against the competition. A tin can is alleged to be more

biodegradable than an aluminium can. To serve different markets, Jumex also packages in plastic, glass and juice boxes.

Presently, Jumex exports only about 20 per cent of its production but it is highly successful. It has operations in Latin America and the Caribbean, North America, Europe, Asia and Oceania. Distribution and marketing have been adapted to fit each country. In most of Latin America, because of geographic, market and cultural similarities, the distribution system that was implemented was very similar to that found in Mexico.

Jumex has been surprisingly successful in the US market, where it is now a leading brand of fruit nectars. Part of this success can be attributed to Mexico's lower production costs and the availability of inexpensive natural resources. Another reason is the predominance of Mexican immigrants across the United States, particularly in large urban areas. Whether these are new immigrants or the children of immigrants who travel frequently to Mexico, they know the product and are familiar with the tropical fruits, creating an initial market for the product. Other Latin Americans or immigrants from tropical areas familiar with the brand or the fruits also push demand.

In 2013, understanding the fact that children comprise approximately one-third of Mexico's entire population, the Swiss company Capri-Sun decided to enter and become a key player within the Mexican beverage market. Capri-Sun entered the market after securing a licensing agreement with Jumex. It acknowledged the fact that Jumex was already a popular Mexican juice producer, which had acquired an expertise in marketing, and Capri-Sun knew it would stand a greater chance of competing with an already established organisation at its side.

In 2014, Mexico introduced a new tax on sugary drinks which resulted in the sales of beverages declining for many firms such as Coca-Cola and PepsiCo. In order to compensate for higher levels of tax, it was reported that bottle production lines had laid off over 1,600 employees in 2014 and raised prices by 16 per cent. Furthermore, Coca-Cola FEMSA's juice sales, operating under the Jugos del Valle brand, also experienced a large hit from the introduction of the new tax. However, Jumex decided that it would be too dangerous to pass the tax costs on to consumers, opting to keep its prices the same. Four years after Mexico's sugar tax, reportedly, the impact in long-term consumption levels was very small. Moreover, research by Autonomous Technological Institute of Mexico (ITAM), the Autonomous University of Nuevo Leon (UANL) and the Colegio de México

(COLMEX), found that the poorest households in Mexico were impacted the most as they usually spend a larger proportion of their income on the consumption of soft drinks.

An important factor that has helped Jumex in developed countries is that its products are considered healthier than carbonated drinks and tend to offer more fruit content than many of the company's domestic competitors. However, competition in developed countries is likely to heat up in the future as Ceres, a South African juice producer, Jugos del Valle of Mexico, and new entrants from Asia compete on price, quality and variety of fruit juices. In the health market sector, organic fruit juices from developing and developed countries will also offer competition.

Website: www.jumex.com.mx; https://www.foodbev.com/news/lessons-mexico-sugar-tax-hasnt-worked-says-beverage-association/.

Sources: 'Soft drinks in Mexico', *Euromonitor*, June 2004; Samuel Bernal, 'Jumex le saca jugo al cómputo movil', *Revista Red*, Febrero 2001; www.jumex.com.mx; B. Bouckley, '$2bn brand Capri-Sun: Mexico offers "enormous growth potential"', 29 April 2013, accessed from www.beveragedaily.com; A. Guthrie, 'Mexican soda tax effect waning, Coca-Cola Femsa says', *Wall Street Journal*, 22 October 2014.

1 How has Mexico provided the environment to make Jumex into a competitive fruit and nectar producer in foreign markets?

2 What factors mentioned in this case study have contributed to Jumex's success in the US market?

3 Can you think of any other factors that may have contributed to Jumex's success in the US market?

REAL CASE

GlaxoSmithKline in the United States

Among industrialised countries, the US market for pharmaceuticals is the least regulated and thus the largest in the world. Not surprisingly, European companies like AstraZeneca, Aventis and GlaxoSmithKline (GSK) depend more heavily on the North American market for their revenues than on Europe as a whole. Europe is a more fragmented market, with individual distribution systems and more layers of regulation, and governments are in the habit of imposing price controls. As a result, Europeans spend 60 per cent less per capita on pharmaceuticals than their American counterparts.

With \$39.18 billion in revenues and 95,490 employees in 2018, GSK is one of the largest pharmaceutical companies in the world. Although headquartered in the United Kingdom, it is not surprising that GSK manages its operations in the United States. Some 39 per cent of its sales originate in this host nation, a fact that is consistent with world trends – the United States accounts for 40 per cent of the world market for pharmaceuticals, while the European market accounts for 26 per cent. GSK derives 35 per cent of its sales from the rest of the world.

Approximately 30 years ago, British Glaxo was a small company in the dried milk, antibiotics, respiratory drugs and nutritional businesses. The discovery of Zantac, a drug to treat stomach ulcers, catapulted the company into the mainstream pharmaceutical market and financed its expansion into the US market. As the patent for Zantac was about to expire, Glaxo found itself in a sticky situation. Up to that point the company had relied on internal R&D, but this had failed to develop the R&D capabilities for sustainable long-term growth. In 1995, the company merged with Wellcome, a company known for its strength in R&D and its lack of marketing capabilities. The merger was successful in that the new company now had a stream of new drugs that could be marketed using Glaxo's expertise.

By 2000, Glaxo Wellcome was disappointing investors once again. Drug prospects, at least in the short term, were below the industry average and expected revenues from some of its products never materialised. Yet the merger with SmithKline Beecham was not driven by the same urgency as the previous merger. Both companies had a reasonably stable pipeline and a balanced portfolio of drugs. According to Sir Richard Sykes, then Chairman of Glaxo Wellcome, the deciphering of the human

genome would transform the industry and only large companies that could afford to invest in working with this new information would succeed. Together, these two companies are immune to the near-death experience of losing a major blockbuster drug. No one drug accounts for more than 12 per cent of the company's revenues.

GSK operates in two product-based industry segments: (1) pharmaceuticals, which include prescription drugs and vaccines; and (2) consumer healthcare, which includes over-the-counter (OTC) medicines, oral care and nutritional healthcare. Prescription drugs are sold mainly to wholesalers, which dispense them to the public through pharmacies. Consumer healthcare products are sold through pharmacies, wholesalers or directly to retail outlets. In 2009, GSK acquired a series of R&D-intensive firms, including Stiefel Laboratories, Pfizer's HIV business, the Algerian pharmaceutical, manufacturing and distribution group, and NovaMin Technology. The periodic acquisition and integration of new R&D pipelines and expertise helps the firm refresh its new product development process. The first step in the development of a drug is R&D. In 2018, GSK spent around $5 billion on R&D and has 11,000 of employees working in research in 20 R&D sites around the world. Once GSK has developed a new drug, it must obtain government approval in every individual nation where the company markets the product, a process that can differ significantly in each jurisdiction. Production and marketing are the next steps for a new drug. GSK's supply chain is divided into a primary chain and a secondary chain. The primary chain manufactures active ingredients for its products and ships them to the secondary chain, which manufactures the end product. There are 13 primary supply-chain sites based in Australia, India, Ireland, Singapore, the United States and the UK. In Europe, there are 17 secondary supply-chain sites, while North America houses an additional six sites. The rest of the world has 32 secondary sites in 19 countries (5 in the Middle East and Africa, 22 in Asia-Pacific, and 5 in Latin America).

Different price regulations at a national level have created some market abnormalities in each region. For instance, Canadian web-based pharmacies have sprung up to service US consumers seeking cheaper alternatives. GSK sent a heavily worded letter to Canadian wholesalers that were selling to these pharmacies and threatened to stop supplies. In Spain, GSK developed a two-price system: one lower price for products to be sold in Spain and a higher price for those to be exported to other EU member countries. The EU found this practice illegal.

Websites: www.gsk.com; www.aventis.com; www.astrazeneca.com

Sources: Alan M. Rugman, *The Regional Multinationals* (Cambridge: Cambridge University Press, 2005); 'The trouble with cheap drugs', *The Economist*, 29 January 2004; GSK, *Annual Report*, 2009, 2014, 2018; Thomson Reuters, *OneSource*, 2011; Statista, *Distribution of the Total Global Pharmaceutical Market Value from 2006 to 2014, by Submarket*, 2015.

1 How is GSK's production organised?

2 Is GSK's secondary supply-chain structure global, regional or local? Why?

3 What is GSK's basic strategy?

4 Why does GSK spread R&D around the world?

5 What factors have made North America the primary market for GSK? Would the situation be different if we measured units sold? Why?

NOTES

1 *Summary of the US–Canada Free Trade Agreement* (Washington, DC: US Department of Commerce, International Trade Administration, 1988), p. 12.

2 https://www.international.gc.ca/gac-amc/index.aspx?lang=eng

3 https://data.oecd.org/canada.htm

4 https://www.retailcouncil.org/research/retail-fast-facts/

5 https://data.oecd.org/mexico.htm#profile-economy

6 Also, see Bob Ortega, ‘Some Mexicans charge north in NAFTA’s wake’, *Wall Street Journal*, February 22, 1994, pp. B1, 5.

7 http://www.oecd.org/investment/MEXICO-trade-investment-statistical-country-note.pdf; ‘Mexico foreign direct investment races ahead as Brazil sputters’, *Financial Times*, 25 August 2015.

8 https://en.wikipedia.org/wiki/Confederation_of_Mexican_Workers

9 http://www.itamaraty.gov.br/en/politica-externa/integracao-regional/5975-aladi-en

10 J. R. D’Cruz and Alan M. Rugman, *New Concepts for Canadian Competitiveness* (Toronto: Kodak Canada, 1992).

BIBLIOGRAPHY

Aguilera, Ruth V., Ciravegna, Luciano, Cuervo-Cazurra, Alvaro and Gonzalez-Perez, Maria Alejandra. 'Multilatinas and the internationalization of Latin American firms', *Journal of World Business*, vol. 52, no. 4 (2017).

Anderson, John and Sutherland, Dylan. 'Developed economy investment promotion agencies and emerging market foreign direct investment: the case of Chinese FDI in Canada', *Journal of World Business*, vol. 50, no. 4 (2015).

Buchanan, Sean and Marques, José Carlos. 'How home country industry associations influence MNE international CSR practices: Evidence from the Canadian mining industry', *Journal of World Business*, vol. 53, no. 1 (2018).

Caliendo, Lorenzo and Parro, Fernando. 'Estimates of the trade and welfare effects of NAFTA', *Review of Economic Studies* (November 2014).

De Hoyos, Rafael E. and Iacovone, Leonardo. 'Economic performance under NAFTA: a firm-level analysis of the trade–productivity linkages', *World Development*, vol. 44 (2013).

Feils, Dorothee J. and Rahman, Manzur. 'Regional economic integration and foreign direct investment: the case of NAFTA', *Management International Review*, vol. 48, no. 2 (2008).

Feinberg, Susan E. 'Do world product mandates really matter?', *Journal of International Business Studies*, vol. 31, no. 1 (spring 2000).

Feinberg, Susan E. and Keane, Michael P. 'US–Canada trade liberalization and MNC production location', *Review of Economics and Statistics*, vol. 83, no. 1 (2001).

Globerman, Steven and Shapiro, Daniel M. 'Governance infrastructure and US foreign direct investment', *Journal of International Business Studies*, vol. 34 (2003).

Gomez, Carolina. 'The influence of environmental, organizational, and HRM factors on employee behaviors in subsidiaries: a Mexican case study of organizational learning', *Journal of World Business*, vol. 39, no. 1 (February 2004).

Hejazi, Walid and Safarian, A. E. 'NAFTA effects and the level of development', *Journal of Business Research*, vol. 58, no. 12 (December 2005).

Hufbauer, Gary C. and Schott, Jeffrey J. *NAFTA Revisited: Achievements and Challenges* (Washington, DC: Institute for International Economics, 2005).

Husted, Bryan W., Montiel, Ivan and Christmann, Petra. 'Effects of local legitimacy on certification decisions to global and national CSR standards by multinational subsidiaries and domestic firms', *Journal of International Business Studies*, vol. 47, no. 3 (2016).

Javalgi, Rajshekhar Raj G., et al. 'Foreign market entry mode behavior as a gateway to further entries: the NAFTA experience', *International Business Review*, vol. 19 (2010).

Kandogan, Yener and Hiller, Jens. 'Alliances in international governmental organizations, regional trade agreement formation, and multinational enterprise regionalization strategy', *Journal of International Business Studies*, vol. 49, no. 6 (2018).

Keane, Michael P. and Feinberg, Susan. 'Advances in logistics and the growth of intra-firm trade: the case of Canadian affiliates of US multinationals', *Journal of Industrial Economics*, vol. 55, no. 4 (December 2007).

Lahrech, Abdelmounaim and Sylwester, Kevin. ‘The impact of NAFTA on North American stock market linkages’, *North American Journal of Economics and Finance*, vol. 25 (2013).

Lovett, Steven R., Coyle, Tom and Adams, Russell. ‘Job satisfaction and technology in Mexico’, *Journal of World Business*, vol. 39, no. 3 (August 2004).

Lovett, Steven R., Pérez-Nordtvedt, Liliana and Rasheed, Abdul A. ‘Parental control: a study of US subsidiaries in Mexico’, *International Business Review*, vol. 18, no. 5 (October 2009).

Rugman, Alan M. ‘The role of multinational enterprises in US–Canadian economic relations’, *Columbia Journal of World Business*, vol. 21, no. 2 (summer 1986).

Rugman, Alan M. (ed.). *North American Economic and Financial Integration* (Oxford: Elsevier, 2004).

Rugman, Alan M. ‘Thirty years of international business scholarship in Canada’, *Canadian Journal of Administrative Sciences*, vol. 25, no. 4 (2008).

Rugman, Alan M. and D’Cruz, Joseph R. ‘The ‘double diamond’ model of international competitiveness: the Canadian experience’, *Management International Review*, vol. 33, no. 2 (1993).

Rugman, Alan M. and Verbeke, Alain. ‘Foreign subsidiaries and multinational strategic management: an extension and correction of Porter’s single diamond framework’, *Management International Review*, vol. 33, no. 2 (1993).

Sargent, John and Matthews, Linda. ‘The drivers of evolution/upgrading in Mexico’s maquiladoras: how important is subsidiary initiative?’, *Journal of World Business*, vol. 41, no. 3 (September 2006).

Schmitz, Troy G. and Lewis, Karen E. ‘Impact of NAFTA on US and Mexican sugar markets’, *Journal of Agricultural and Resource*

Economics, vol. 40 (2015).

Waldkirch, Andreas. ‘The effects of foreign direct investment in Mexico since NAFTA’, *World Economy*, vol. 33, no. 5 (May 2010).

Weinstein, Bernard L. and Seman, Michael. ‘Has the North American Free Trade Agreement fulfilled its promise? An assessment after 15 years’, *Regional Science Policy and Practice*, vol. 1, no. 2 (November 2009).

Weintraub, Sydney. *Unequal Partners: The United States and Mexico*, Pitt Latin American Series (Pittsburg, PA: University of Pittsburgh Press, 2010).

Wisner, Priscilla S. and Epstein, Marc J. ‘“Push” and “pull” impacts of NAFTA on environmental responsiveness and performance in Mexican industry’, *Management International Review*, vol. 45, no. 3 (2005).

Chapter 19

EMERGING ECONOMIES

Contents

Objectives of the chapter

More than 100 nations in the world are not triad members; they lie outside North America, Europe and Japan. An important subgroup of non-triad countries is the 'emerging economies', marked by their rapid economic growth and changing involvement in the global economy. They are

increasingly important for MNEs of all sizes: as growing markets whose large populations are starting to have more and more disposable income; as increasingly important sources of inputs, including products, technology and value-adding capabilities as well as commodities and cheap labour; and as a source of competition, as non-triad firms begin to internationalise into triad markets. These developments represent many new opportunities as well as new risks for MNEs. Increased involvement in emerging market regions for managers means coping with more diversity. This includes the broad cultural, political and economic diversity resulting from the wide range of countries outside the triad. It also includes diversity of business practices and competitors, which MNEs need to adapt to in order to survive.

The specific objectives of this chapter are to:

1. *Examine* the relative attractions, opportunities and threats in the triad regions and emerging economies for firms looking to internationalise.
2. *Explain* how many emerging economies are becoming more integrated into the global economy, in terms of trade, FDI and other forms of interaction and interdependence.
3. *Understand* the nature of the new multinationals from emerging economies, as collaborators and competitors.
4. *Examine* the implications of changes in emerging economies for MNE managers in terms of new strategies and organisation structures.

ACTIVE LEARNING CASE

Acer Taiwan goes international

Acer Taiwan ranks as one of the largest PC companies in the world. In 2018, the overall Acer Group of companies was comprised of over 7,000 employees, plus dealers, and distributors in more than 100 countries, earning revenues of $7.37 billion for the year. Around 38 per cent of its sales were generated from Asia Pacific, 35 per cent from EMEA (Europe, Middle East, Africa), and 27 per cent from Pan America, making it a balanced multinational in terms of sales. The company is one of the best-known brands in Asia, and a large player in Latin America. In the United States, where HP and Dell dominate, Acer is one of the largest competitors in the consumer electronics market. According to the Statista, with a market share at 6.1 per cent, Acer ranked number 5 in terms of market share held by the leading personal computer vendors worldwide in 2018. Not bad for a company no one knew just a few decades ago.

In 1976, CEO Stan Shih and some of his friends managed to pull together $25,000 to start Multitech. With seven employees, the company began developing small electronic products such as pocket calculators and games. Slowly the company began to grow by commercialising microprocessor technology and its applications. Its initial entrance into the PC market was as a supplier. Multitech began producing computers to be sold under other brand names. Then in 1986 the company launched its own brand name computer, Acer, and it began to sell in Europe and in Japan. While the firm still supplies under other brand names, Acer has become one of the best-known PC brands in the world.

How did a small company from Taiwan gain market share in an industry dominated by well-established computer manufacturers? Two key strategies underpinned its rapid international growth.

First, it focused on learning: actively developing technological know-how, innovation capabilities, and, later, marketing and branding expertise. It invested in engineering training, initially with the help of the Taiwanese government. In the late 1970s it founded the Microprocessor Training Center where 3,000 engineers were trained for Taiwan's information industry. It also entered into a range of subcontracting relationships and joint ventures with major

multinational firms in targeted industries. One of the most prominent was its DRAM semiconductor joint venture with Texas Instruments in 1989. To acquire necessary technologies the company bought a host of firms including Counterpoint Computers, Altos and Kangaroo Computer. It also entered into cross-licensing agreements with firms like IBM and Intel. Innovation was the constant focus. The rapid development of engineering, design and R&D capabilities helped Acer improve both its production efficiency and its product development capabilities. In 1986 it came out with a 32-bit PC model before IBM. In 1994 it introduced the world's first dual Intel Pentium PC, in 2001 the first Chinese Palm OS, and in 2004 a 64-bit notebook PC.

Second, Acer followed an incremental, niche strategy in order to expand internationally. Stan Shih explains this decision by noting, 'It is better to be a big fish in a small pond than a small fish in a big pond.' Small markets, especially in Asia, which had not yet been captured by the likes of IBM and Compaq, were a driving force behind Acer's initial international success.

Acer's distribution system was also a novelty. With the product life of computer components at about three months, exporting overseas becomes a problem, but Acer built manufacturing and assembling plants all over the world. The company distributed parts with long product lives by ship, while highly volatile products like processors, PCBs and memory were shipped by plane. This allowed for just-in-time production that Shih compared to the distribution system of a fast-food chain with perishable and non-perishable ingredients.

The success of the company also owes much to the management structure created by Shih. Unlike traditional Chinese businesses, where management is highly hierarchical and controlled by the owning family, Shih uses decentralised management. Autonomy is important. Managers are encouraged to think like owners, so as to take advantage of all profit opportunities. Additionally, Acer has gone public and employees have the option of buying shares at extremely low prices.

In 2000, Acer spun off its manufacturing operations to focus on globally marketing its brand name products: desktop and mobile PCs, servers and storage, displays, peripherals, and e-business solutions. This began a shift away from production and into design and branding (since 2004 it has produced a 'Ferrari' line of notebook PCs), and service-related businesses, partly following the evolution of the industries mapped out by Stan Shih's Smiling Curve in the early 1990s. He

predicted that success in the combined computing, IT, consumer electronics and telecoms industries would increasingly depend on being customer-centric, with customer-driven rather than technology-driven innovation. The firm would need to be committed to providing outstanding service and developing intellectual property such as software, rather than focusing on hardware and production activities.

The retirement of Stan Shih in 2004 led to a significant organisational change at the firm, but it maintained its core strategy under J. T. Wang, who has been Chairman of the Board and Chief Executive Officer in Acer Incorporated since 20 April 2011. A more devolved decision-making structure has evolved across a more international group of senior managers, a process accelerated by a number of large acquisitions as well as disposals. Acer's buyout of US-based Gateway in 2007 compares to Lenovo's (successful) takeover of IBM's PC business in 2004 and BenQ's (unsuccessful) takeover of Siemens' PC division more recently. This helped Acer move ahead of Chinese rival Lenovo by strengthening its position in the US retail market and giving it control of Packard Bell in Europe. But the competitive threat posed by mainland Chinese PC and electronics firms remains a key strategic challenge for Acer. In 2010 the firm established its second mainland China manufacturing base in Chongqing and it is now calling this its 'global IT centre'.

Websites: www.acer.com; www.ti.com

Sources: Kathrin Hille and Kevin Allison, 'Acer to leapfrog Lenovo with Gateway deal', *Financial Times*, 27 August 2007; 'Acer buys Gateway', *Financial Times*, 28 August 2007; Willie Chien, Stan Shih and Po-Young Chu, *Business Growth Strategies for Asia Pacific* (New York: Wiley, 2005); Daniel Lyons, 'Horse power', *Forbes*, 16 February 2004, p. 56; Paul Taylor, 'In the CEO's chair: Ky Lee at BenQ', *Financial Times*, 17 March 2004, p. 2; Kathrin Hille, 'A head start of being ethnically Chinese', *Financial Times*, 7 April 2004, p. 10; Stanley Shih, 'Talking about innovation', *Far Eastern Economic Review*, 17 October 2002, p. 44; Stan Shih, *Growing Global* (Taiwan: Acer Corporation, 2001); Stan Shih, *Me-Too Is Not My Style* (Taiwan: Acer Corporation, 1996); Acer, *Annual Report*, 2006–18; Thomson Reuters, *OneSource*, 2011; Mintel Global Market Navigator, 2011, http://gmn.mintel.com.dblibweb.rdg.ac.uk:4000/snapshots/USA/56/shares/single;

https://www.linkedin.com/company/acer; https://www.statista.com/statistics/267018/global-market-share-held-by-pc-vendors/.

1. **What was the internationalisation strategy of Acer and why was it successful?**
2. **How are changes in the Asian regional economy, in terms of both growing markets and growing competitors, affecting Acer and how should the firm cope?**
3. **Why did Acer form strategic alliances with IBM and Texas Instruments?**

INTRODUCTION

In Chapter 14 we examined some of the country-level risks common in emerging market countries. Although these stand out because of their rapid growth rate, they share many of the characteristics of non-triad countries in general. Such countries are:

- growing in importance for international managers for both market-seeking investments and resource-seeking investments;
- strongly government controlled, in that government agencies play a central role in negotiating with foreign investors and deciding the local rules of the game;
- less predictable and riskier than triad markets, which investors often underestimate in their pursuit of the high level of rewards on offer; and
- the source of new competitors, as local firms move up the value chain, becoming more sophisticated and more international.

We are concerned with two broad kinds of international expansion in this chapter: first, internationalisation from the triad into non-triad regions, whereby established MNEs, whose home base is large and mature, and includes expensive markets, expand to sell more outputs in, or buy more inputs from, cheaper emerging economies; and second, the internationalisation of newer MNEs from outside the triad which are looking both to complement home-market resources with assets or capabilities from inside the triad and to sell into the much larger triad countries. For each kind of MNE these two forms of internationalisation represent some major strategic threats and opportunities.

TRIAD FIRMS AND EMERGING ECONOMY FIRMS: WHY THE MUTUAL ATTRACTION?

Triad-based and non-triad-based firms will have similar objectives when exploring market-seeking investments. They both want to increase sales in each other's territories and to do this they must customise products and services to suit these markets, establish (or buy) distribution and sales networks, and raise the profiles of their brands. In many cases they may also need to set up manufacturing, assembly, service, or support activities in each other's markets to avoid import duties and/or to support the needs of customers.

When exploring input-seeking investments, triad-based and non-triad-based firms may also have similar strategies, but they tend to be looking for different kinds of inputs. This is because their home regions provide each with a different set of factor endowments, as described by the Porter diamond model (see Chapter 10).

Figure 19.1 provides a starting point to understand the attraction for triad firms looking to expand into emerging economies and for firms from emerging economies looking to expand into triad regions. The large markets of North America, Europe and Japan still dominate the global economy, but they are growing slowly relative to emerging markets both large, like India, China and Brazil, and small, like Poland and Malaysia. Triad regions also tend to be more expensive, in terms of labour costs, infrastructure, land, materials and supporting industries, relative to non-triad regions. These represent push factors, accentuating the pull of non-triad locations.

Combining these differences means that there are strong incentives for triad-based firms both to sell products, services and other outputs into these growing markets and to source inputs, such as cheap labour or manufactured components and services, from such places.

For new MNEs evolving in non-triad regions, the main attraction of triad markets is the large, mature markets. But many firms also look to these countries to fill gaps in their assets, resources and capabilities, from technological know-how or specialist components to brands.

FDI into emerging economies for inputs (**resource-seeking FDI**) and outputs (**market-seeking FDI**) takes a variety of forms. Prudential (UK), along with many other triad firms, cut many of its back-office operations in Reading, England, over a decade ago and established a centre in Mumbai, India. Although this resulted in around 400 redundancies in the UK, the firm was then able to take advantage of the cheaper (and, in some cases, better) local Indian IT and call-centre service workers who have created the local industry reviewed in the **Real Case: The Indian IT, software and services industry** at the end of this chapter. Contrasting these firms, the **Active Learning Case: Acer Taiwan goes international** shows why and how newer MNEs have broken into triad markets. Yet in many other cases, such as Tesco in the case **International Business Strategy in Action: From Oserian to Tesco**, firms do not see a need to engage in FDI, because they can get access to the advantages of non-triad locations and maintain control over their supply chains by buying and selling through global markets.

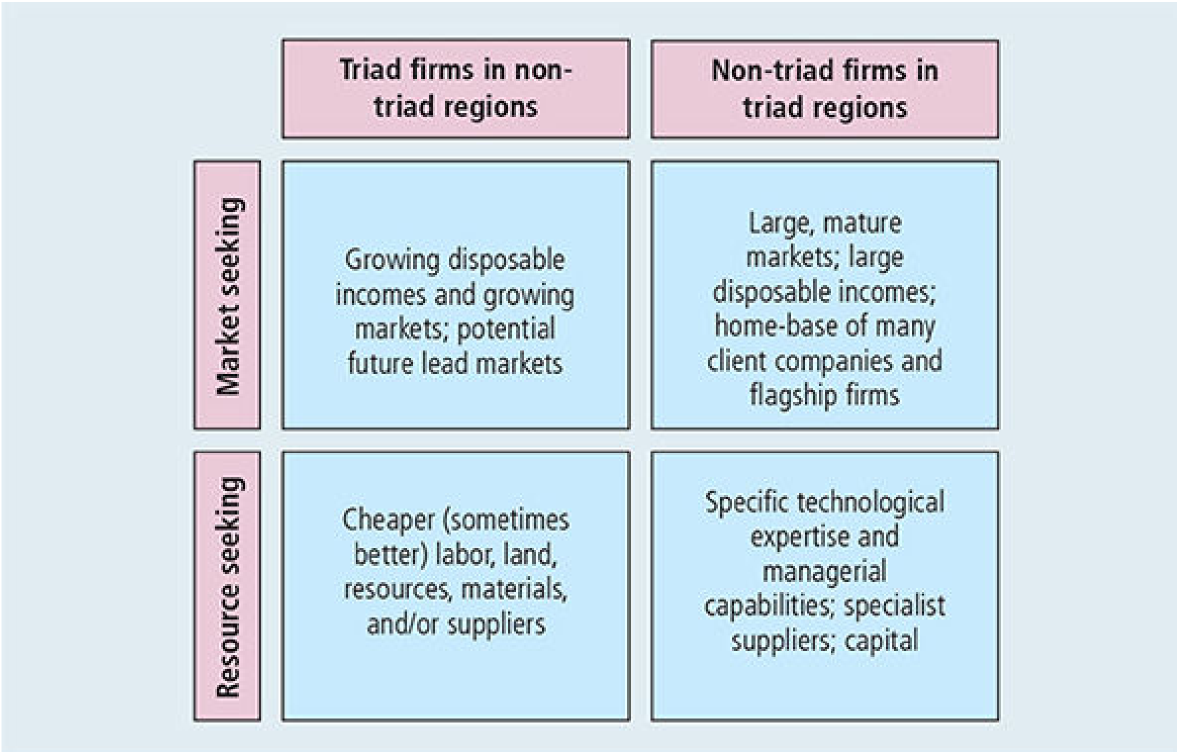

Figure 19.1 What is the attraction for triad and non-triad firms investing in each other's home regions?

More generic international business reasons also exist for expanding into these markets, including risk diversification, the opportunity to extend economies of scale and scope and the opportunity to leverage existing assets or resources for additional revenues. For example, expanding global production by establishing manufacturing plants in non-triad regions serves to diversify risk by reducing dependence on triad locations where input costs and wages are high – but may also rise further. This allows firms to reap economies-of-scale benefits across the overall production function. Similarly, extending established triad brands into new markets helps build the economies of scale needed to pay for media advertising and other brand-building activities. As sports stars and celebrities, from Tiger Woods or Cristiano Ronaldo to Taylor Swift, or Instagrammers, YouTubers and influencers, like PewDiePie or Lele Pons, develop international reputations,

their images can be used to sell products around the world, and companies can earn sufficient revenues to pay for them because they are assets that can be leveraged globally.

Active learning check

Review your answer to Active Learning Case question 1 and make any changes you like. Then compare your answer to the one below.

1 What was the internationalisation strategy of Acer and why was it successful?

Rather than aiming to break into the triad markets directly, despite the attractions, Acer focused on building a presence in smaller local Asian markets first. In some ways it followed a pattern of gradual, stepwise internationalisation. Acer built up from its relatively small home-base diamond in Taiwan and expanded production throughout Southeast Asia. It then undertook a double-diamond strategy for accessing the triad markets of North America and Europe. It formed strategic alliances with the US and European MNEs and used these as a stepping stone to FDI in these key triad markets. It also kept its production-based efficiencies of employee involvement in company growth and ongoing R&D to improve the quality of its products.

AN OVERVIEW OF EMERGING ECONOMIES, BY REGION

This growing interest between triad and non-triad regions is apparent in the changing patterns of global FDI. As Table 19.1 shows, over 40 per cent of all FDI now flows into developed countries, mainly the triad. This compares to 85 per cent in 1980. Asia, and particularly Southeast Asia, takes the major share of the remaining 47 per cent going to developing countries, with 28 per cent of the world total, compared to a share of just 1 per cent in 1980 and 12 per cent in 1990. Africa receives less than 4 per cent. Overall, though, FDI is the largest source of external finance for all developing countries and on average now amounts to over one-third of their GDP, compared to just 10 per cent in 1980. As described below, patterns of inward FDI are varied, with some countries or regions showing significant growth while others experience no growth and even decline.[1]

Table 19.1 FDI inflows, by host region and economy, 1995–2018 (millions of US$)

Economy/region	1995	2000	2005	2008	2014	2018
World	335,734	1,387,953	916,277	1,697,353	1,467,233	1,297,152
Developed countries	204,426	1,107,987	542,312	962,259	696,854	556,892
European Union	114,560	671,417	421,899	503,453	333,084	277,640
North America	68,027	380,798	133,265	360,824	301,333	291,438
United States	58,772	314,007	99,443	316,112	230,768	251,814
Japan	41	8,323	2,775	24,426	2,304	985,7
Other developed countries	17,251	29,752	−27,356	83,095	69,987	93,575
Developing countries	115,953	252,459	334,285	620,733	670,790	706,042
Africa, of which	5,392	8,728	30,672	87,647	53,969	45,902
Algeria	0	438	1,081	2,647	2,661	1,506
Egypt	595	1,235	5,376	9,495	4,192	6,797
Morocco	332	215	2,933	2,388	3,298	3,640
Sudan	12	392	2,305	2,601	1,688	1,135
Angola	472	879	−24	15,548	−7,120	−5,732
Chad	33	116	705	834	538	662
Equatorial Guinea	65	109	1,860	1,290	1,914	395
Nigeria	1,079	930	3,403	20,279	5,608	1,997
South Africa	1,241	888	6,379	9,009	11,018	5,334
Latin America and the Caribbean	30,280	97,537	103,663	144,377	186,151	146,720
Argentina	5,609	10,418	4,662	8,853	11,301	12,161
Brazil	4,405	32,779	15,066	45,058	63,996	61,223
Chile	2,956	4,860	6,667	16,787	16,577	7,160
Colombia	968	2,395	10,192	10,564	16,199	11,009
Ecuador	452	720	1,913	974	731	1,401
Peru	2,557	810	2,579	4,808	9,298	6,175
Venezuela	985	4,701	2,957	1,716	2,680	956
Mexico	9,655	16,586	18,055	21,950	44,627	31,604
Asia	81,703	142,031	224,575	378,481	459,982	511,706
Saudi Arabia	21,877	21,884	1,469	38,223	8,865	3,208
Azerbaijan	330	130	1,680	11	2,632	1,403
Kazakhstan	964	1,283	1,738	14,543	10,221	3,816
China	37,521	40,715	72,406	108,312	123,911	139,043
Hong Kong, China	6,213	61,939	35,897	63,003	74,294	115,661
India	2,151	2,319	6,598	41,554	28,199	42,285
Indonesia	4,346	24,550	5,260	7,919	18,817	21,979
South Korea	1,249	8,572	7,198	7,603	12,767	14,479
Malaysia	5,815	3,788	3,967	8,053	12,115	8,091
Pakistan	719	305	2,183	5,438	1,333	2,352
Singapore	11,591	17,217	20,083	22,725	64,793	77,646
Taiwan Province of China	1,559	4,928	1,625	5,432	3,598	6,998
Thailand	2,070	3,350	3,687	10,091	14,016	10,492
Vietnam	1,780	1,289	2,020	8,050	8,900	15,500
Bulgaria	90	1,002	2,223	9,205	1,920	2,058
Croatia	114	1,089	1,695	4,383	955	1,159
Romania	419	1,037	6,388	13,305	3,602	5,887
Russian Federation	2,065	2,714	14,600	70,320	69,219	13,332

Source: Adapted from United Nations, *World Investment Report*, 2006, 2009, 2014, 2018 key data downloads at http://www.unctad.org (Geneva: United Nations Conference on Trade and Development).

Given the market-seeking and resource-seeking aims of MNE investors, we can see that the varying levels of attractiveness of different non-triad

investment destinations are the result of differences in market size and growth rates and the opportunities they present for firms looking for sourcing and production advantages. Opportunities for accessing these kinds of advantages can be enhanced by government **liberalisation policies**, which can help to reduce the limitations and constraints on foreign firms' investments and business activities. Liberalisation, for many governments in emerging economies, signals a move away from a centrally controlled or coordinated economy, towards a more liberal market economy. This shift is often accompanied by the widespread privatisation of state-owned firms. Again, this presents opportunities for MNEs – for example, in telecoms, utilities or energy industries – to buy into newly privatised firms or establish joint ventures and alliances to access resources or the local market. India provides a clear illustration of this with FDI inflows amounting to over $2 billion between 1991 and 1995, after liberalisation, compared to well below $1 billion in the two decades leading up to 1990.

Non-triad countries and regions differ, both in their initial economic attractiveness to MNEs and in the ways that governments are liberalising parts of the economy; together these explain many of the differences we observe in regional patterns of FDI. Table 19.2 shows that, developed countries still dominate as the source of most outward FDI; 76 per cent in 2018 (about 42 per cent from Europe and 25 per cent from North America). But in the past few decades, outflows of FDI from developing countries have grown fairly dramatically. Again, Southeast Asia is responsible for the dominant share. China's stock of outward FDI has grown from $2.5 billion in 1990 to over $25 billion in 2000, and over $60 billion in 2007. It then grew at its fastest rate, to over $148 billion in 2008 and close to $2,000 billion in 2018. China is now responsible for nearly 13 per cent of all FDI outflows. In addition to this, however, a significant proportion of the much

larger outward flows from Hong Kong originally come from mainland China.

We will now briefly review the recent experience of each of the main non-triad regions in terms of inward FDI and look at some examples that provide insights into the drivers of FDI flows. In preparation for the discussion below about MNEs from emerging economies, we will also briefly look at some of the largest firms in these countries that are expanding within and beyond their regions.

Asia-Pacific and the Middle East

As shown in Table 19.1, Asia-Pacific and the Middle East receive a large percentage of global FDI flows, the most of any non-triad region. But FDI is highly concentrated, with a few leading countries and particularly China and Hong Kong (China) receiving a significant share of regional FDI, indicating their attractiveness to investors.

Table 19.2 FDI from developing countries, 2008–18 (billions of US$)

	FDI outflow	FDI outward stock			
Region/economy	2018	2000	2008	2013	2018
Developing economies	417.6	862.3	2,356.6	4,993.3	7,523.7
Africa	9.8	44.1	97.9	162.4	318.1
South Africa	4.6	32.3	62.3	110.9	238
Latin America and the Caribbean	6.5	204.3	561.4	1,312.3	658.7
Brazil	−13.0	51.9	162.2	293.3	229.1
Chile	3.0	11.2	31.7	101.9	119.3
Mexico	6.9	8.3	45.3	143.9	152.5
Asia	401.5	596.6	1,823.2	3,646.2	6,544.9
China	129.8	27.7	147.9	613.6	1,938.9
Hong Kong, China	85.2	388.4	775.9	1,352.3	1,870.1
India	11	1.8	61.7	119.8	166.2
South Korea	38.9	26.8	95.5	219.1	387.6
Malaysia	5.3	15.8	67.5	134.0	118.9
Memorandum					
World	1,014.2	6,069.8	16,205.6	26,312.6	30,974.9

Source: UNCTAD, *World Investment Report*, 2006, 2009, 2014, 2018 at www.unctad.org; https://unctad.org/en/Pages/DIAE/World%20Investment%20Report/Annex-Tables.aspx.

We focus on China in the next chapter, but there are examples of events and factors elsewhere in the region that help explain these patterns of investment. Many of the countries in the region continue to liberalise their economies and privatise state-owned assets, both of which are attractive to MNEs. Cross-border M&A has grown steadily, as has the significance of intra-regional M&A, as opposed to investments driven by triad-based firms. But a few large acquisitions and divestments can make a big difference to individual country markets.

FDI into India grew dramatically (around six-fold) between 2005 (US$6,598 million) and 2008 (US$41,554 million), decreased between 2008 and 2013 and increased again to 2018. A growing economy, continued liberalisation, and the attractiveness of evolving IT, software and services industries (see **Real Case: the Indian IT, software and services industry**) all provided the initial momentum. GM and IBM increased their presence as did Walmart, Toyota and Nissan.

The oil-rich countries of Bahrain, Jordan, Kuwait, Oman and Saudi Arabia also experienced upturns in inward FDI, almost exclusively related to their oil industries. These peaked in 2008–09 and have declined since. Less political turmoil would clearly have resulted in larger inflows to the Middle East region in recent decades.

Finally, there are two clear trends that indicate the dynamism of the Asia region. First, the growth of **intra-regional investment** is particularly driven by the regional giants India and China joining countries like Malaysia, South Korea, Taiwan and Singapore as active investors, but also by the growth of Japanese investment in the region. Second, FDI in services is growing rapidly and now represents the major proportion of FDI stock in the Asia

region. Many of the high-growth economies are becoming increasingly service oriented and have developed efficient institutional and infrastructural conditions for attracting finance, telecoms and commerce-related activities. In accordance with its commitments to the liberalisation of services under its WTO accession agreement, China is opening its service industries to FDI. Restrictions on FDI in industries such as banking and finance, telecoms, logistics and distribution, transportation, and retail and wholesale trade are being removed.

MNEs from Asia-Pacific

The Asia-Pacific region has a large proportion of the largest non-financial MNEs from developing countries listed by UNCTAD (see Table 19.3). Hong Kong (China) and China are very well represented. Top of the list is CK Hutchison Holdings Limited, a diversified retailer and conglomerate which focuses on the Asia region. Other major firms from the region include Petronas (oil and petroleum; Malaysia), China COSCO Shipping, Samsung Electronics (South Korea) and Tata Motors (India).

Outward FDI from India has increased significantly in recent years. Indian companies undertake cross-border M&As to gain access to new technologies and expertise, and to build stronger positions in global markets. Further discussion about new multinationals from non-triad regions appears below.

Central and eastern Europe

Despite years of political and economic change, including liberalisation, in the Central and East European (CEE) region, it still attracts a relatively small percentage of global FDI inflows. Poland, the Czech Republic and Hungary receive larger shares of FDI than other countries in the region but have experienced declines in recent years, as has the Russian Federation. These,

plus five other CEE countries (Estonia, Latvia, Lithuania, Slovenia and Slovakia), joined the EU in May 2004 and saw FDI inflows shrink, but things have improved since then.

Table 19.3 The top 50 non-financial TNCs from developing economies ranked by foreign assets, 2018a (millions of US$, number of employees)

Ranking by: Foreign assets	TNI[b]	Corporation	Home economy	Industry[c]	Assets		Sales		Employment		TNI (Per cent)
					Foreign	Total	Foreign	Total	Foreign[d]	Total	
1	12	CK Hutchison Holdings Limited	Hong Kong, China	Retail Trade	125 804	140 795	25 036	31 890	279 000	300 000	87.0
2	9	Hon Hai Precision Industries	China	Electronic components	95 809	114 824	151 752	154 650	824 063	987 612	88.3
3	51	China COSCO Shipping Corp Ltd	China	Transport and storage	84 419	109 044	22 800	34 668	8 091	100 550	50.4
4	36	Samsung Electronics Co., Ltd.	South Korea	Communications equipment	83 371	282 814	183 963	211 859	215 541	308 745	62.0
5	79	China National Offshore Oil Corp	(C China	Mining, quarrying and petroleum	67 282	173 408	21 348	81 482	12 738	97 986	26.0
6	96	State Grid Corporation of China	China	Electricity, gas and water	60 000	585 299	45 003	343 796	16 535	913 546	8.4
7	48	China National Chemical Corporation	China	Chemicals and Allied Products	56 241	121 444	32 788	59 226	86 025	158 425	52.0
8	67	Tencent Holdings Limited	China	Computer and data processing	51 012	85 236	1 183	35 178	26 809	44 796	41.0
9	85	China Minmetals Corp (CMC)	China	Metals and metal products	42 790	131 338	17 308	72 997	13 348	203 786	20.9
10	25	Tata Motors Ltd	India	Motor Vehicles	42 146	50 844	36 577	45 820	39 795	81 090	70.6
11	77	Formosa Plastics Group	China	Chemicals and allied products	39 412	131 715	16 870	67 155	37 545	112 996	29.4
12	40	América Móvil SAB de CV	Mexico	Telecommunications	37 581	75 331	39 344	54 022	101 559	191 865	58.6
13	53	Vale SA	Brazil	Mining, quarrying and petroleum	37 369	99 042	30 060	34 015	15 527	73 062	49.1
14	72	Petronas - Petroliam Nasional Bhd	Malaysia	Mining, quarrying and petroleum	37 213	148 209	36 968	51 996	8 984	49 911	38.1
15	95	China State Construction Engineering Corp Ltd	China	Construction	36 583	238 338	12 577	155 961	22 008	270 467	10.5
16	86	Hanwha Corporation	South Korea	Wholesale petroleum and fuels	34 485	150 141	6 757	44 573	12 152	52 909	20.4
17	33	Naspers Ltd	South Africa	Telecommunications	30 091	35 344	3 115	6 058	13 439	24 887	63.5
18	39	Singapore Telecommunications Ltd	Singapore	Telecommunications	28 733	36 796	8 013	12 924	9 783	25 000	59.7
19	46	Legend Holdings Corporation	China	Computer equipment	27 165	61 828	40 141	56 299	26 123	59 457	53.1
20	52	Hyundai Motor Company	South Korea	Motor vehicles	26 507	167 015	77 582	85 226	51 410	118 320	50.1
21	61	Jardine Matheson Holdings Ltd	Hong Kong, China	Wholesale durable goods	26 196	82 814	26 467	39 456	148 356	469 001	43.4
22	15	Cemex S.A.B. de C.V.	Mexico	Stone, clay, glass, and concrete products	24 934	28 769	10 477	13 649	31 593	40 878	80.2
23	42	CapitaLand Ltd	Singapore	Construction	24 485	45 989	2 044	3 338	4 517	8 484	55.9
24	32	Wilmar International Limited	Singapore	Food & beverages	24 409	40 933	34 916	43 846	53 668	90 000	66.3
25	59	New World Development Ltd	Hong Kong, China	Construction	24 341	55 998	3 432	7 292	19 126	44 000	44.7
26	74	Fosun International Limited	China	Metals and metal products	23 882	82 027	6 965	13 024	20 381	70 000	37.2
27	64	Lukoil OAO	Russian Federation	Petroleum refining and related	22 922	90 325	83 552	101 721	17 612	103 600	41.5
28	99	China National Petroleum Corp	(CNP China	Mining, quarrying and petroleum	22 447	629 846	9 187	346 260	56 000	1 355 000	3.5
29	83	Sun Hung Kai Properties Ltd	Hong Kong, China	Construction	21 482	81 926	1 307	10 071	12 152	38 000	23.7
30	62	Sinochem Group	China	Mining, quarrying and petroleum	20 724	64 110	59 319	76 763	9 591	52 755	42.6
31	5	First Pacific Company Ltd	Hong Kong, China	Food & beverages	19 662	20 455	6 925	7 297	98 553	102 530	95.7
32	37	Lenovo Group Ltd	China	Computer equipment	19 626	28 496	33 993	45 576	16 929	45 754	60.2
33	87	Oil and Natural Gas Corp Ltd	India	Mining, quarrying and petroleum	19 289	70 621	1 616	56 187	8 813	32 265	19.2
34	17	Ooredoo QSC	Qatar	Telecommunications	19 257	24 610	6 853	8 993	13 315	17 016	77.6
35	65	Midea Group Co Ltd	China	Electric equipment	17 701	38 126	15 458	35 793	35 000	101 826	41.3
36	56	Etisalat - Emirates Telecom Corp.	Emirates	Telecommunications	17 629	34 931	5 321	14 068	19 939	39 508	46.3
37	24	Genting Bhd	Malaysia	Hotels and restaurants	17 287	23 130	2 984	4 655	40 880	56 000	70.6
38	41	JBS SA	Brazil	Food & beverages	17 206	32 812	38 810	51 801	109 040	235 000	57.9
39	55	DP World Limited	Emirates	Transport and storage	16 957	23 113	1 445	4 729	18 450	45 000	48.3
40	70	Fomento Economico Mexicano SAB	Mexico	Food & beverages	16 930	29 831	8 407	24 348	85 026	295 097	40.0
41	68	Sasol Limited	South Africa	Chemicals and allied products	16 671	30 514	6 647	12 675	4 842	30 600	41.0
42	11	Quanta Computer Inc	China	Computer equipment	16 629	20 671	29 319	33 553	85 000	90 000	87.4
43	94	Sinopec - China Petrochemical Corp	China	Petroleum refining and related	16 448	346 784	90 557	355 140	44 256	667 793	12.3
44	19	MTN Group Ltd	South Africa	Telecommunications	16 357	19 788	6 780	9 975	18 814	25 424	74.9
45	76	Huawei Technologies Co, Ltd	China	Communications equipment	15 527	77 637	44 169	89 309	35 000	180 000	29.6
46	80	POSCO	South Korea	Metals and metal products	15 442	74 065	19 254	53 638	3 545	17 005	25.9
47	47	CLP Holdings Ltd	Hong Kong, China	Electricity, gas and water	14 961	29 195	7 999	11 815	3 031	7 634	52.9
48	30	Abu Dhabi National Energy Co PJSC	Emirates	Electricity, gas and water	14 585	28 055	2 603	4 542	2 457	2 700	66.8
49	88	China Three Gorges Corp	China	Electricity, gas and water	14 333	107 706	2 697	13 316	3 053	22 946	15.6
50	26	YTL Corporation Bhd	Malaysia	Construction	14 309	17 398	2 493	3 436	6 232	11 000	70.5

Source: UNCTAD. [a] All data are based on the companies' annual reports unless otherwise stated; corresponds to the financial year from 1 April 2016 to 31 March 2018.

[b] TNI, the Transnationality Index, is calculated as the average of the following three ratios: foreign assets to total assets, foreign sales to total sales and foreign employment to total employment.

[c] Industry classification for companies follows the United States Standard Industrial Classification as used by the United States Securities and Exchange Commission (SEC).

[d] In a number of cases foreign employment data were calculated by applying the share of foreign employment in total employment of the previous year to total employment of 2017.

Some countries are attracting auto sector FDI, including the Czech Republic, with an investment from Toyota–PSA, and Slovakia, with investments from PSA, Kia and Hyundai. Volkswagen Slovakia is already that country's largest company and biggest employer by far. Slovakia has a population of just over 5.4 million people, yet has developed into a leading producer of autos, reaching an output of over one million cars back in 2014, from having no auto industry whatsoever before 1991, when VW took over Skoda's businesses in Bratislava in the Czech Republic. VW has invested around $1.3 billion in Slovakia, and Hyundai's investments are higher than this. But in all these cases the MNEs were attracted to the region not just because of the combination of cheap labour, good infrastructure and proximity to Europe's large markets, but also because of the over $1 billion in subsidies and regional development loans they received to sweeten the deal.

In terms of outflows of FDI from the CEE region, the Russian Federation has dominated for some time as the major source, peaking in 2013 and rising again in 2017. A key question for analysts is whether these capital flows represent genuine strategic investments in other parts of the world or capital flight from a politically tense Russia.

MNEs from central and eastern Europe

The largest MNEs in the CEE region are Russian, most of them nationally owned at one time or another and many of them based on the country's abundant natural resources. The Russian oil and gas giants (Gazprom and Lukoil) have started to expand abroad, including Gazprom's investments in the German energy sector to get direct access to end-users (also see the **Real Case: Yukos and the Russian oligarchs**). Telecoms, aluminium and other industries also feature in the international expansion of CEE firms.

Latin America and the Caribbean

Approximately 11 per cent of global FDI went to the Latin America region in 2018, down from over 12 per cent in 2014 and still lower than inflows to China and Hong Kong (China) that year. The three largest economies of Argentina, Brazil and Mexico have seen large fluctuations in inflows in the recent past. To various degrees these economies have had a difficult decade in terms of economic growth and recession. A spate of privatisations during the late 1990s gave a temporary boost to inward FDI for these and other regional economies and a number of MNEs increased their involvement in Latin America during this period. A peak year was 2011 and there has been a steady decline since then.

Regional-level, as opposed to national-level, competition has evolved in other industries, sometimes pitting home-based MNEs against foreign-owned incomers. In telecoms, for example, Mexico's América Móvil and Spain's Telefónica have battling it out for regional domination, both having boosted their holdings when US telecom firms went through a divestment phase. Although the former dominates the Mexican mobile telephony business, it has a long way to go to catch up with Telefónica. Telefónica Móviles, the Spanish firm's regional mobile telecom subsidiary, has a presence in most countries in the region and serves a total of over 40 million customers.[2]

Brazil and Mexico still receive the highest amounts of FDI and, as we would expect, one-third of all FDI into the region came from the United States. Many Latin American countries now face increased competition for US manufacturing investment from China and the Asia region. This is particularly true of Mexico, whose linkage to the North American triad via NAFTA was discussed in Chapters 10 and 18, where the Mexico–US double diamond was explained. Various periods have seen a decline in the number of *maquiladora* enterprises (which once accounted for almost 50 per cent of Mexico's merchandise exports) and associated jobs losses. Combined with the decline in inward FDI, this called into question the attractiveness and competitiveness of the region in comparison to a fast-evolving Asia.

MNEs from Latin America

Of the largest non-financial TNCs from developing countries listed by UNCTAD (Table 19.3), a relatively small number are from the Latin American region. As with the central and eastern European MNEs (and contrasting those from the Asia–Pacific region) many of the largest are natural resources based. These include the largest of all, Vale (mining and petroleum, Brazil) and Cemex (construction materials; Mexico), the abovementioned America Movil (telecoms, Mexico) and JBS (food and beverages, Brazil).

Africa

As home to most of the world's least developed countries (LDCs), Africa has always recorded low levels of inward FDI because of its relative lack of attractiveness to MNEs. Political instability, weak infrastructure, poor labour skills and macroeconomic fragility have plagued many parts of the continent for decades. Except for the larger economies of Egypt and South Africa, and the oil producers such as Equatorial Guinea, Angola, Nigeria and the Sudan,

most of the remaining LDCs normally receive less than $500–600 million FDI per year.

As shown in Table 19.1, only approximately 3.5 per cent of total global FDI went to Africa in 2018, and this tends to be concentrated in resource-rich economies. Oil, diamonds, gold and platinum in particular have been the main attraction for MNEs. Exxon Mobil, for example, has offshore oil projects in Nigeria, and the French firm Total Oil Nigeria has investments in the Nigerian oil industry. For most of Sub-Saharan Africa, however, inflows are limited, although South Africa stands out as a major recipient due to its relatively healthy economy. Chinese investment into Africa, particularly targeting sources of raw materials and resources, is very much in the news. FDI worth an estimated $30–40 billion, much of it from state-owned enterprises, has flowed into Sub-Saharan Africa, but accurate data are not yet available.

FDI in telecoms and services overtook investment in mining and extraction in South Africa some time ago. It has also extended its investments in other parts of the continent, with firms like BHP Billiton (mining) and Eskom (utilities) expanding into other African markets.

Two of South Africa's telecom firms are also majority shareholders in the largest mobile telecom firm in Africa, a joint venture between Telecom SA, VenFin and Vodafone (minority stake) with over 15 million subscribers. It competes with MTN Group from South Africa, Orascom (Egypt), Orange (France Telecom) and Celtel International (the Netherlands), all of which are gradually taking market share from the fixed-line industry dominated by national telecom firms, giving rise to new mobile services (see the **Real Case: M-Pesa** in Chapter 15). In some industry sectors, despite the lack of inward FDI, there are growing business links between Western firms and local African firms. The Kenya cut flower industry is one example (see **International Business Strategy in Action: From Oserian to Tesco**).

INTERNATIONAL BUSINESS STRATEGY IN ACTION

From Oserian to Tesco: the Kenyan cut flower industry

Kenya is one of the leading exporters of flowers in the world, accounting for approximately 38 per cent of the market share in Europe in 2017. Kenya's roses, carnations and summer flowers are famed for being long-lasting and extremely popular in other nations such as Russia and the United States. This industry took off in the first half of the 2000s, with export growth accelerating rapidly in the late 1990s and achieving 27 per cent between 2001 and 2005. How did this global competitive advantage evolve in one of the world's least developed countries?

In 2017, horticultural and cut flower exports provided well over $800 million to Kenya's economy. Kenya's floriculture industry exported approximately 160,000 tons in 2017. The country has approximately 10 per cent of the global export market. Ecuador and Colombia are key competitors and the Netherlands still dominates with over 50 per cent. The major markets are Germany, the UK and United States, but the major proportion of exports goes to the Dutch auction houses in Holland. Direct sales via supermarket chains, particularly in the UK, have increased dramatically, however.

As of 2017, the country's flower industry employs about 100,000 people, and it has been reported that the industry indirectly supports around 2 million people in Kenya. The average basic wage in the flower industry is around US$5,000 compared to Kenya's average GDP per capita of $1,594. Most of the flower growing is in the areas of Naivasha, Thika and Kiambu, where over 2,000 hectares are used for flower production. Although over 30 varieties of flowers are grown in Kenya, roses make up two-thirds of Kenya's flower exports, followed by carnations, statice and alstromeria. The real start of the industry happened in 1994 with the formation of the Kenya Flower Council to support the operations of a number of fast-growing businesses.

Local factor conditions

The successful cultivation of flowers requires the following elements:

- good physical conditions: high light intensity, abundant water, clean soil, good climate;

- appropriate seeds and planting material;
- capital for investment and working capital;
- productive labour;
- expertise in growing techniques;
- good management and organisation;
- pesticides and other chemicals;
- energy for heating;
- infrastructure;
- a high level of quality consciousness all along the production and post-harvesting chain.

Perhaps more than any other internationally traded good, time-to-market is critical in the cut flower industry. Strict control of humidity, temperature and air quality is essential for delivering an attractive product to the market. Growers rely heavily on the post-harvest chain of handlers, storage and transport, and in the absence of a 'cold chain' it is not possible for equatorial producers to sell to the main northern markets.

Air freight adds significantly to the total cost and makes up by far the largest component of overall cost to African producers. Air freight, marketing, handling in Europe and packaging make up 50 per cent of all costs for Kenyan growers. In the Netherlands, however, transport accounts for just 14 per cent of the costs, but labour makes up 35 per cent of costs.

Although cheap labour and a good growing climate are advantageous for growing flowers, some countries have done well for some time without these local factor endowments. The Netherlands does not have climatic, land or labour advantages but has been a dominant player in the industry for a long time. This is partly due to the power of the Dutch auction houses, which have long overseen the international flower trade.

In Porter's terminology (in the diamond model discussed in Chapter 10), acquired factor conditions, such as the cold transport infrastructure, plant breeding and greenhouse technologies, and production management capabilities were required before Kenya could leverage its natural endowments and the cheap labour advantage to compete in the open market. It is only in the last 15 to 20 years that these acquired factors have developed.

Another 'diamond of advantage' factor, the influence of government, has had a significant effect over the last two decades. A cycle of political instability has arguably limited investment as internal and external funders do not have confidence in the sustainability of the flower-growing industry.

The Oserian Development Company

Oserian ('place of peace' in Maasai), one of the largest privately owned flower farms in the world, was among the first commercial exporters of cut flowers from Kenya. Although it began growing flowers in the early 1980s, the company dates from 1967 and was started and is still operated and partly owned by Hans and Peter Zwager. It has over 200 hectares under cultivation next to Lake Naivasha in the Rift Valley and exports over 300 million stems per year. These are mainly sold by East African Flowers (EAF) BV, through the Tele Flower Auction (TFA) in Holland, to other buyers around the world; or by World Flowers in the UK, direct to Tesco. Crops include roses, spray carnations, gypsophila, chrysanthemums, statice, hypericum, euphorbia, delphinium and perezi. The farm employs about 5,000 people; 85 per cent are permanent employees and over 60 per cent live on the farm with their families. The facilities include three kindergartens, two primary schools, a secondary school, shopping centres, social halls and a medical centre.

Industry structure: Tesco and the growing power of the supermarkets

Although the Dutch auction houses have traditionally been the focal point of the world flower industry, large retailers are building direct links with growers around the world, using their purchasing power to gain better control over product price, delivery and quality. African producers appear to be the main beneficiaries of this change in purchasing habits. Supermarkets are interested in African flowers because they are inexpensive and because growers are willing to accept a set price. To the growers this arrangement is attractive because supermarkets buy large quantities at prearranged prices. But in order to live up to their side of the bargain, African growers must invest in optimal production methods. Often this includes investments in greenhouses, forced ventilation and heating, and, in all cases, greater attention to quality.

Over the past decade Kenya's direct imports to the UK have grown, partly due to the establishment of direct links with Marks & Spencer and Tesco. The British spend more than $3

billion a year on fresh cut flowers and indoor plants; 85 per cent of all flowers sold in the UK are imported, of which about 20 per cent come from countries outside the EU.

Around one-quarter of roses sold in the UK are purchased directly from Kenya, mainly by the major supermarkets. Tesco, one of the top three supermarket chains in the world, is the UK's number one food retailer and the largest retailer of flowers and plants. Tesco has been selling houseplants and flowers for the last two decades and sales keep growing, hence the need for reliable ties with suppliers. Tesco became an associate member of the Kenya Flower Council in early 2000 as its direct links with suppliers like Oserian began to grow. By cutting out the Dutch auction houses, Tesco found that it could work directly with growers to reduce prices and improve quality and also pass on customer needs to more directly influence new developments.

Fairtrade

Tesco and Oserian deepened their buyer–supplier alliance by opening a line of Fairtrade roses. These are grown by Oserian and one other farm in Kenya (Finlay Flowers in Kericho), which have been certified to comply with employment, social and environmental conditions laid down in the Fairtrade agreement.

The agreement was set up in response to concerns among customers and expressed in the media about the conditions under which flowers are grown. This included the employment conditions of workers and the environmental effects on the land and particularly water availability, around, for example, Lake Naivasha. Although Fairtrade roses are slightly more expensive, they represent a differentiated product designed to appeal to ethically minded customers. Tesco does not take an additional profit as 8 per cent of the overall export price goes directly to the farms, allocated by joint management and employee committees, to improve employee conditions. This premium is worth up to US $200,000 per year to the two farms involved. This concern for social ethics has strengthened as Oserian became part of the Mavuno Group in 2010 and expanded its direct sales to more global markets.

In 2015, the Kenyan farmers started lending their floral expertise to neighbouring country Rwanda. As part of a government partnering scheme, in 2015 the two nations signed to build a 35-hectare flower park which is 60 km away from Rwanda's capital city, Kigali. The aim of this

partnership was to produce over 3 million stems per year, which was said to provide employment and pump approximately $200 million into Rwanda's economy by 2017.

Sources: Milena Veselinovic, 'Got roses this Valentine's Day? They probably came from Kenya', *CNN Africa View*, 16 March 2015; http://www.oserian.com; A. Odhiambo, 'Oserian deal with Dutch firm sparks rivalry', *Business Daily*, April 2011; 'Roses are red: Kenya's flower industry', *The Economist*, 7 February 2008; Gathoni Muraya, 'Local flower market quietly booming', Business Day Africa, 28 March 2007; C. S. Dolan, S. Jafee and R. Thoen, 'Equatorial rose: the Kenyan–European cut flower supply chain', in R. Kopiki (ed.), *Supply Chain Development in Emerging Markets* (Boston, MA: MIT Press, 2004); Mary Hennock, 'Kenya's flower farms flourish', *BBC News*, 14 February 2002; Chris Collinson, *The Business Costs of Ethical Supply Chain Management Report No. 2607*, Natural Resources and Ethical Trade Programme (Chatham: National Resources Institute, 2001), at http://www.nri.org/NRET/2607.pdf; further material from the KFC at http://www.africaonline.co.ke/kfc/index.html; industry data from the Horticultural Crop Development Authority (HCDA), Nairobi; http://www.tesco.com/corporateinfo/; https://data.worldbank.org/indicator/NY.GDP.PCAP.CD?locations=KE; http://kenyaflowercouncil.org/?page_id=92.

MNEs from Africa

Just 7 of the 100 largest non-financial TNCs from developing countries listed by UNCTAD (Table 19.3 shows the top 50) are from Africa, and all but one are South African. Sasol (industrial chemicals), MTN (telecoms), Naspers (telecoms), Steinhoff (consumer services), Mediclinic International (healthcare), Aspen Pharmacare (pharma). Sonatrach (mining and petroleum) is an Algerian firm. At least part of the explanation for the lack of large indigenous firms from other African countries lies in their colonial past and the history of domination by Western multinationals as investors in local mineral or agricultural resources.[3]

SHIFTING PATTERNS OF COMPARATIVE AND COMPETITIVE ADVANTAGE

As we have seen from the breakdown of FDI flows above, FDI into non-triad regions tends to be concentrated in a few countries within each region. Moreover, although FDI still tends to be related to primary resources, such as oil, minerals and agricultural commodities in many of these countries, there is a growing volume of manufacturing and service-related FDI. This is particularly true for a group of emerging markets or **newly industrialised countries (NICs)**, which have broken the cycle of underdevelopment to achieve economic growth and wealth creation, partly through increased integration with other parts of the global economy. This group includes relatively wealthy countries like South Korea, Singapore, Hong Kong (China) and Taiwan (China), which were together called the 'four Asian Tigers' in the 1980s when they began to achieve high rates of economic growth. But there are also other growing economies, particularly in the Asia-Pacific region, that appear to be moving along the same growth path. Why are these economies growing? How are they able to compete with triad firms, export and sell in triad markets? Why are they attractive as locations for triad FDI? These are important questions as the emergence of these economies, particularly the two giant markets of China and India, is giving rise to some of the most important competitive opportunities and threats for MNEs of all types.

To understand current patterns of growth in many emerging markets, we need to briefly review some of the theoretical explanations for the evolving patterns of national-level comparative and competitive advantage (we did this in Chapter 6 and some of the following summarises our earlier

description). In the original landmark study of wealth creation and national competitiveness, the economist Adam Smith stated:

> What is prudence in the conduct of every private family, can scarce be folly in that of a great kingdom. If a foreign country can supply us with a commodity cheaper than we ourselves can make it, better buy it of them with some part of the produce of our own industry, employed in a way in which we have some advantage. The general industry of the country, being always in proportion to the capital which employs it, will not thereby be diminished . . . but only left to find out the way in which it can be employed with the greatest advantage.[4]

Adam Smith's theory of absolute advantage suggested that each nation should *specialise* in producing goods it had a *natural* or *acquired* advantage in producing (and therefore could produce more efficiently than other countries). Exports of these goods would pay for the import of goods that other countries produced more efficiently. There were therefore *net gains from trade* for all countries involved. Smith also became famous for his analysis of specialisation and competitive advantage at the firm level.

Over time Smith's views were extended, for example, by David Ricardo's theory of comparative advantage. A notable shift towards looking at sources of competitive advantage and regional variations in these to explain global patterns of competitiveness came in the early 1900s. Two Swedes – Eli Heckscher (in 1919) and Bertil Ohlin (in 1933) – are responsible for developing a basic model that was further refined by the American economist Paul Samuelson. The H–O or HOS model (or theory of factor endowments) takes us beyond the simple assumptions made by Ricardo about labour productivity to look at the *relative availability* of different factors of production (primarily land, labour, and capital) and therefore their *relative price* (rent, wages and interest) in each country. These will determine the products in which a country has a comparative advantage, and in which it will therefore tend to specialise and trade.

The HOS model maps out the initial conditions for regional specialisation in capital-intensive or labour-intensive industries according to local factor advantages, but it is also a dynamic model, showing how economic conditions change as countries interact through trade. These theories underpin the Porter diamond model (see Chapter 10). They are also incorporated into the interestingly named **Flying Geese model** by Japanese academic Kaname Akamatsu.[5]

Flying Geese model

The Flying Geese model (Figure 19.2) suggests that Asian economies are following similar development paths, but are at different stages along this path, following the lead 'goose', Japan. Over time each country, or group, will gain and then subsequently lose specific comparative advantage in a particular industry. Japan has shifted from iron and steel to textiles to clothing to autos to electronics. The four Tiger economies – Hong Kong, South Korea, Singapore and Taiwan – followed a similar trajectory, although quicker. Other ASEAN (Association of South-East Asian Nations) members such as Indonesia, Malaysia, the Philippines and Thailand are a little further behind, but the sequence of specialisation is similar. In each country the transition is marked by a shift of employment from one sector to another, within the broader move from agriculture to manufacturing and then to services. Overall, rising skills and improved technological capabilities, increased capital investment and wage inflation (as predicted by the HOS model) drive, and are driven by, the change process.

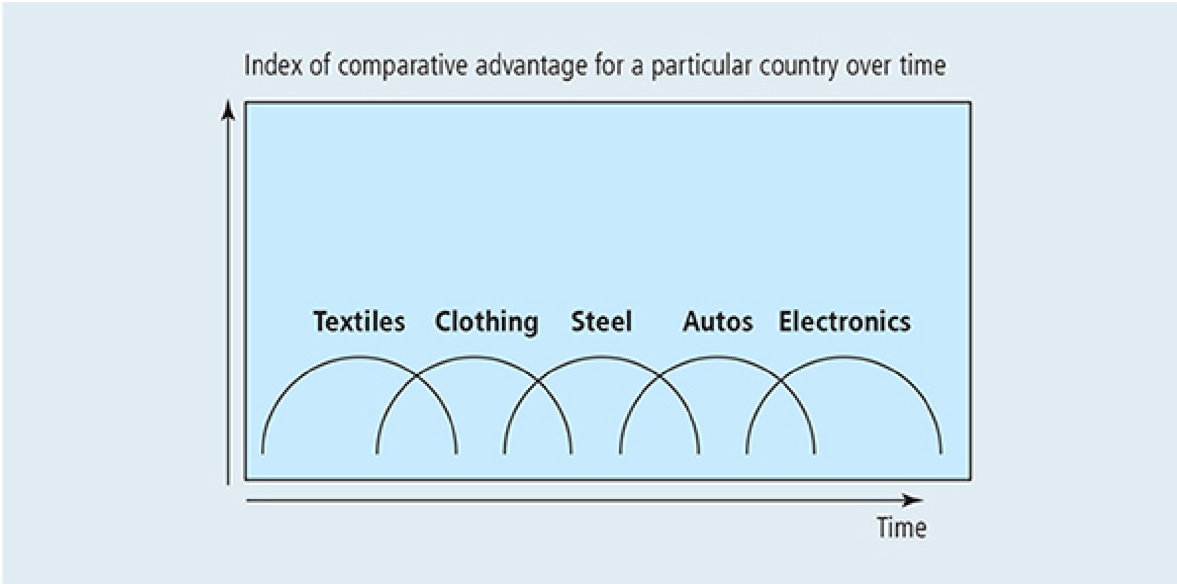

Figure 19.2 Flying Geese model: changing national-level specialisation

If we look at a particular industry, the location of production activities and subsequent exports and trade flows change as different economies change their specialisation (Figure 19.3). China now dominates as the world's biggest exporter of textiles and clothing, Korea has a thriving automobile sector, and Singapore and Taiwan have very successful electronics industries. These have grown to the point that Japan, now a net importer of televisions, is losing its historical lead in many product areas (Figure 19.4). The overall pattern of change is also in line with Vernon's international product life cycle theory (described in Chapter 6).[6]

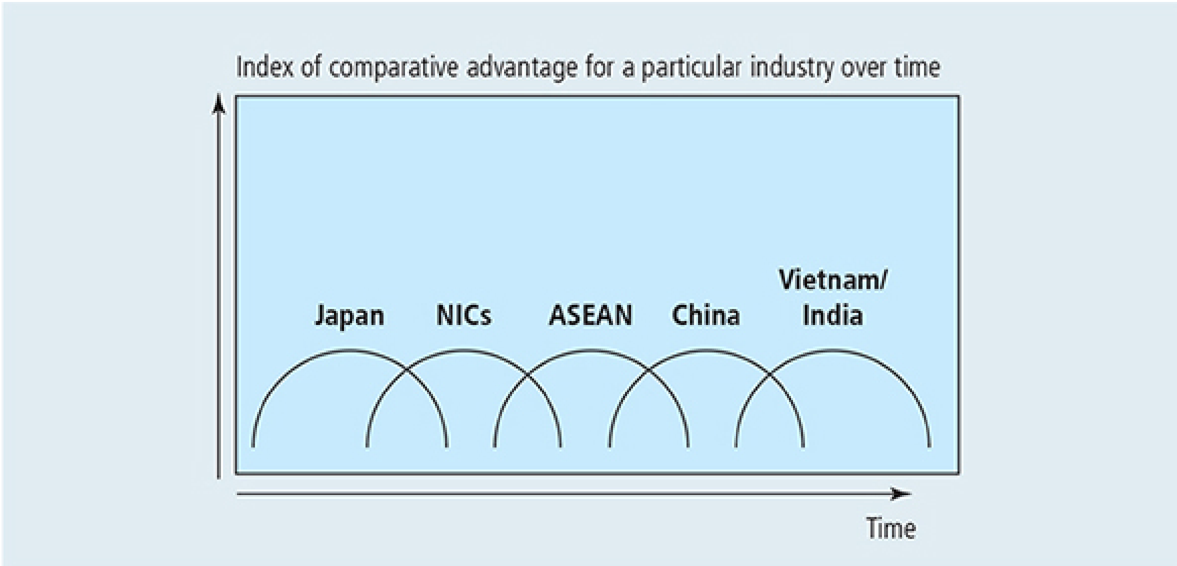

Figure 19.3 Flying Geese model: the shifting location of industrial production

The timescale over which individual countries develop the economic conditions, resources and capabilities to specialise in a particular industry sector appears to be shortening. Comparative advantage between nations is also therefore shifting faster than in the past (Figure 19.5). It took Toyota and Sony 30 to 35 years to evolve into leading firms in their industries, whereas Samsung (South Korea) and Acer (Taiwan) took 20 to 25 years. Firms like WIPRO, Infosys and TCS, which are lead firms in the Indian software industry, achieved superior competitive positions (albeit in niche areas of customised software and IT services) in 15 to 20 years.

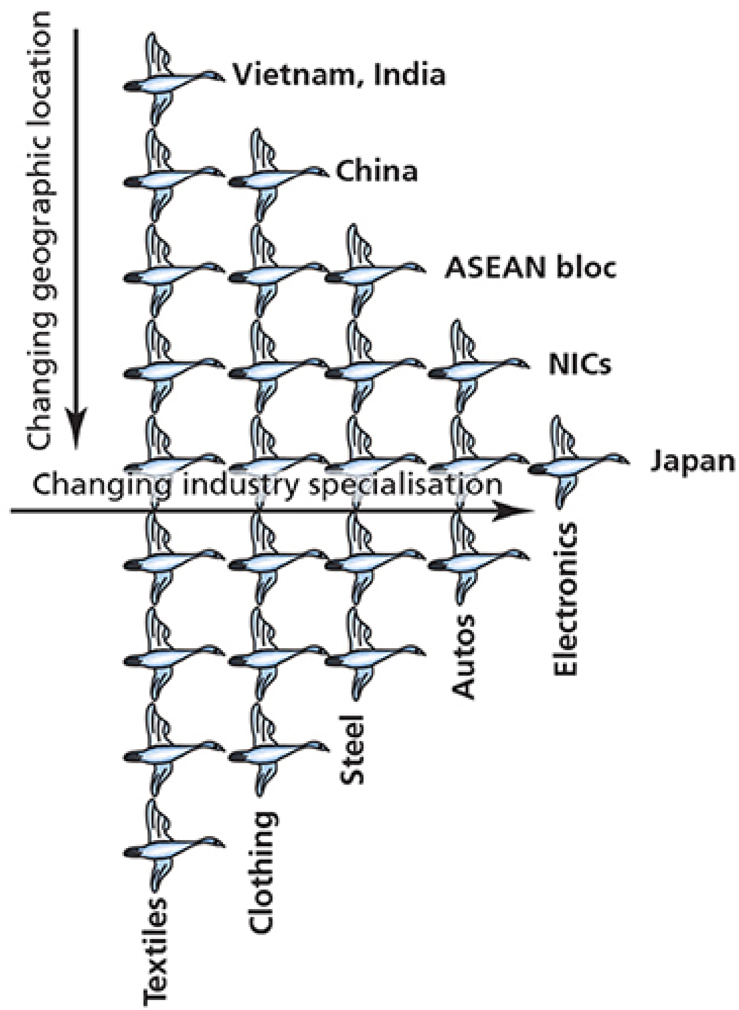

Figure 19.4 Flying Geese model: the pattern of shifting comparative advantage

The Flying Geese model is far from perfect and has been widely criticised on a number of counts. Many studies note that the sequential transfer of industrial specialisation does not follow the same pattern in each country, or that it tends to be more of a parallel process whereby emerging economies seem to develop capabilities and grow exports across several industries at the same time. The example of the Indian IT and services industry (see the **Real Case: The Indian IT, software and services industry**) also demonstrates that leapfrogging is possible. Here an LDC has evolved

competitive advantages in an advanced service sector without going through the stages depicted by the model.

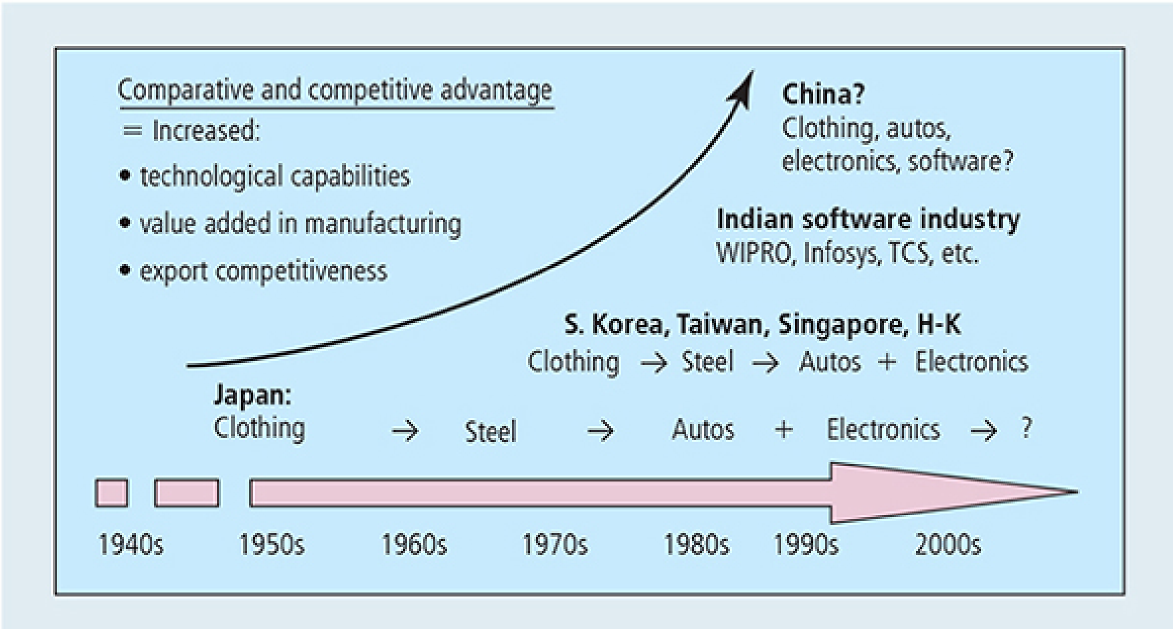

Figure 19.5 **Accelerated structural transformation (are the geese flying faster?)**

For the most critical observers, the model is associated with a desire by Japan to see itself as the lead 'goose' in the region from a political and perhaps military perspective (particularly given that its origins date back to the 1930s), as opposed to a useful representation of patterns of economic transformation.

There are, however, some insights we can gain into the processes affecting the changing global locations of different industries and business activities and into the changing relative competitive advantages between countries. With this in mind we need to think about the future for China – the evolving specialisations of Chinese firms and the resulting competitive threats for other firms. China represents a powerful combination of cheap and well-educated labour, good infrastructure, a growing domestic market and massive inflows of capital and technology from abroad. These are driving the rapid development of comparative and competitive advantage in

a range of industries, including clothing, autos, white goods and electronics. What we may be seeing is parallel development across these sectors, rather than sequential, stage-wise development following the lead goose (as shown in Figure 19.5). This theme is taken up in Chapter 20.

✔ Active learning check

Review your answer to Active Learning Case question 2 and make any changes you like. Then compare your answer to the one below.

2 How are changes in the Asian regional economy, in terms of both growing markets and growing competitors, affecting Acer and how should the firm cope?

Among a range of threats and opportunities, China looms large in both respects. Acer has taken a step in the right direction by moving away from manufacturing, where Chinese firms have natural advantages, and into customer-oriented design, development and services. Acer's advantages also lie in its global distribution and marketing and its brand. These are firm-specific advantages (FSAs), which Huawei or China Mobile and other Chinese firms will take some time to develop. The evolving political relationship between Taiwan and mainland China or the People's Republic of China is also an important factor, influencing some of the strategic options open to firms like Acer. But other parts of Asia, including Japan, are changing and the firm could do well to develop an international strategy that focused more on the regional than the global.

Emerging economies as sources of innovation

A natural extension to the above theories on comparative and competitive advantage is to examine innovation as a relative (and sustainable) source of advantage at the national, industry and firm level. Traditional theories about the MNE tended to view the triad as a source of innovation and non-triad regions as recipients in a simple outward diffusion model. But other studies, which go beyond the Flying Geese model, have shown how firms that develop the independent capacity to innovate, continually upgrading their FSAs and reducing their reliance on location-specific endowments (CSAs), such as cheap labour, can achieve more sustainable competitive advantages.[7]

Specific combinations of country-specific advantages (CSAs) and firm-specific advantages (FSAs) explain Japan's competitive advantage in auto exports, Taiwan's semiconductor industry, and Indian IT and software businesses, for example (see also Figure 19.6). Local conditions (the CSAs) also 'breed' certain organisational forms, assets, capabilities, or expertise (FSAs) that turn out to be relative strengths in other markets. Honda's original export success in the United States came from its ability to make smaller, fuel-efficient autos, which it was forced to do to succeed in the domestic Japanese market during the post-war period. Porter cites demanding customers, industry rivalry, and efficient and effective supply chains (the *keiretsu* structures described in Chapter 17) as key local drivers of the innovative capabilities of Japanese auto firms.[8] Both product and process innovation tend to be important. Continuously learning how to produce better (cheaper, more desirable) products and services in better (cheaper, more efficient, faster) ways is the key. But the dual effects of CSAs and FSAs that lead to international competitiveness can arise by chance as well as by design, and usually result from an unanticipated combination of both.

As the **Real Case: The Indian IT, software and services industry** below and the case **International Business Strategy in Action: From Oserian to Tesco** above both show, firms in developing and emerging economies have an increasing range of opportunities to exploit local endowments and develop new competitive advantages. However, the openness of the global economy means that local players have to compete with MNEs which are also looking to exploit specific CSAs and often have equal access.

Globalising ...	Assets	Capabilities	Connections	Reputation
Innovation and technology	Patents, licences, IPR; specialised tools hardware, software, etc.	Low-end (maintenance) to high-end (blue-sky R&D) expertise	Strategic alliances; buyer and supplier links; R&D networks/ global capability inputs	Credibility, trust, track record, recognition
Marketing and brands	Own valued brands, logos, trademarks, awards, etc.	Brand management protection, development expertise	Formal co-branding; supplier or buyer, distribution, and retailing affiliations	Reputation for quality, price, innovation, etc.; market positioning, brand recognition; market presence

Figure 19.6 Firm-specific advantages (FSAs) for the new multinationals

The Brazilian biofuels industry, for example, has evolved over decades because petroleum has traditionally been expensive and sugar cane cheap and available. Following the government's PróÁlcool programme of incentives, the country gets more than 30 per cent of its automobile fuels from sugar cane-based ethanol (mainly from bagasse which is cane waste); 85 per cent of new cars in Brazil can run on biofuels. In a world where governments, consumers and companies aim to move towards more environmentally friendly sources of energy, Brazil has emerged as a leader in agricultural processing and automotive technologies related to ethanol-based fuels. However, in contrast to India's IT sector, or China's white goods industry, the few, small-scale automotive producers in Brazil appear to have lost out to the multinationals, failing to exploit their own country's head-start in ethanol fuel technologies. GM is seizing the opportunity by establishing a number of joint ventures in Brazil to co-develop better automotive technology in this field. It is gaining a lead in duel-fuel systems and all of its cars produced in Brazil are 'Flex Fuel' vehicles. Rather than being attracted

by low costs, GM's choice of location for its R&D was driven by the need to access the best capabilities available globally.

International studies, including the *World Competitiveness Report*, use science and technology indicators, such as patenting output, to assess and compare the growing innovative capacity of different countries in different industries and technologies. In recent years Singapore, Taiwan, Korea, Malaysia, Chile and the Czech Republic have all ranked well as up-and-coming innovators.[9] The development of world-class universities and other attributes of advanced national science and technology infrastructures (or 'national innovation systems') has made some emerging economies attractive to R&D FDI from MNEs. China ranks third as a preferred location for foreign R&D investment, after the United States and the UK, while India, Singapore and Brazil are all in the top 20. Microsoft, Siemens and Philips have invested heavily into the Republic of Korea, for example, because of the available range of expertise in high-technology fields. Microsoft's Mobile Innovation Lab develops wireless technologies and software for mobile devices. Siemens bought into DASAN Networks and develops communications and information systems technology for its global markets. Following acquisitions of parts of the LG Group, Philips has developed an R&D centre focused on TV technology. This influx of high-technology investment further adds to the importance of emerging economies as sources, rather than passive recipients, of innovation.

MARKET ACCESS TO THE TRIAD

For non-triad firms the triad regions encompass by far the largest, wealthiest and most sophisticated markets in the world. Access can be subject to complex arrangements with varying degrees of economic trade liberalisation and protectionism that are inherent in the institutional and political structures of these regions. The triad represents both globalisation and sovereignty dimensions. The EU is the most politically integrated, in terms of institutional structures, but is showing signs of instability and possible disintegration since Brexit, and the Japanese-based bloc is the least. NAFTA (discussed in Chapter 18) is a free trade agreement, not a common market, but NAFTA contains provisions for the accession of Latin American and Caribbean and Central American nations, and it may then evolve into stronger political linkages like the EU model.

To develop global industries, non-triad nations need both trade and investment from the triad nations and also access to the markets of at least one of the triads. This implies that the focus of business strategy for firms in a smaller, non-triad nation should be to secure inward triad investment and market access for exports to a triad bloc. This can be done by direct business contact of a double-diamond type, but it is helped and reinforced by formal linkages arranged by the governments. As demonstrated in the previous chapter, both Canada and Mexico have already gone down this route.

In general, NAFTA is the basis for a trading bloc of the Americas; the EU is the locus for eastern European and African nations; Japan is the hub for many Asian businesses. Some smaller, non-triad nations may attempt to open the doors to two triad markets. For example, both South Korea and Taiwan have equal trade and investment with the United States and Japan.

Firms from these countries need two double diamonds (see **International Business Strategy in Action: Korean *chaebols***). Australia still has a large amount of trade with the UK and the EU, but its trade with Japan and other Asian nations is increasing rapidly. Indeed, the geographical basis of the triad serves to reinforce the dependence of neighbouring nations on their dominant regional economic partner.

INTERNATIONAL BUSINESS STRATEGY IN ACTION

Korean *chaebols*: Hyundai and Samsung

Between 1970 and 2000, South Korea's GDP grew by 750 per cent. Industrial production increased at an even higher rate and grew to account for over 95 per cent of GDP by 2004. GDP per capita grew from $100 in 1963 to $10,000 in 1995 and just under $30,000 in 2017. The so-called 'Miracle on the Han River' has made the country the eleventh largest in the world in terms of GDP, and it continues to grow faster than most advanced economies.

In South Korea's transition to industrialisation, a transition that many other poor countries have tried to make with little success, *chaebols* played a major role. South Korea still maintains a healthy rate of growth, although it is not as rapid as in the boom years. Despite their central role in the transition years the influence of the *chaebols* has declined. Their opaque, interdependent structures and cross-shareholdings have been increasingly questioned by South Koreans themselves, as well as by outsiders.

There are 16 South Korean firms in the Global Fortune 500 (2018) including the five largest *chaebols*: Samsung Electronics, Hyundai Motor, SK Holdings, LG Electronics and POSCO. Across the world, these companies have become household names, producing everything from ships to autos to electronics. During the 1960s, *chaebols* prospered under a government-fostered development plan. When Park Chung-hee became South Korea's president after a military *coup d'état*, he instituted an import-substitution strategy that favoured large local producers and provided them with cheap credit, tax breaks and other benefits. After Park Chung-hee's death, low-interest loans continued to be made available to *chaebols* because of ties with banks. Since banks could not let a borrower the size of *chaebols* fail, credit was made available regardless of profitability, depriving the non-*chaebol* business sector from much needed credit.

In the 1990s, the *chaebols* took on debt to finance large expansion projects. The Asian financial crisis in 1997–98 reduced their revenues to such an extent that these companies could no longer pay their creditors. For a long time, *chaebols* managed to conceal their troubles by providing member companies with intra-conglomerate loans. In addition, foreign and domestic investors

became increasingly aware of murky financial reporting practices. By the end of the crisis, Daewoo had become bankrupt.

Source: epa european pressphoto agency b.v./Alamy Stock Photo

In 1997, the IMF was called to bail out the South Korean economy after an unprecedented drop on the Korean won created a debt crisis. As part of the bailout, South Korea was to restructure its *chaebols*. Debt-to-equity ratios had to be reduced. Financial reporting had to become transparent. Most importantly, non-core businesses were to be spun off. To oversee the transformation of the *chaebols* and, in turn, the Korean economy, the Financial Supervisory Commission (FSC) was established in 1998. Although *chaebols* have reduced their debt-to-equity ratios, unreliable financial reporting continues to occur. Most importantly, many *chaebols* continue to resist selling off their non-core businesses.

Hyundai Motor and Samsung Electronics are two of the most successful and international firms from South Korea, but they have taken different development paths to get where they are.

Chaebols had their origins in the vision of individuals. In 1946 Chung Ju-yung, who worked as a delivery boy for a rice mill in the 1930s, purchased an auto repair shop that was the early foundation of the Hyundai group. In 1947 Hyundai Engineering and Construction was established to take advantage of reconstruction contracts at the end of World War II. By 1976, Hyundai had brought its country into the auto business with the introduction of the Pony.

Hyundai Automotive spun off from its conglomerate parent and merged with Kia to form one vehicle company, now the fifth largest in the world in terms of (8 million) unit sales. In recent years it has experienced significant increases in overseas sales, particularly in the United States and Europe. As an indication of its standing, Hyundai won top place as the most reliable car manufacturer in an influential consumer survey in the United States, joining Japanese car manufacturers in the top spots for the first time. It has also made significant inroads into the Chinese market, particularly in 2008 with its joint-venture partner Beijing Automotive. In 2018, Hyundai Motor’s revenues were $85 billion, representing an impressive growth from $67 billion in 2006. In 2014, Hyundai Automotive generated 35.2 per cent of its revenue from Asia, 17.9 per cent from North America, 14.1 per cent from Korea and 19.6 per cent from other regions. Hyundai Automotive is a home-region MNE, but within the last five years it has been focusing more on global markets.

In 1938, Lee Byung-chul founded Samsung and began exporting food to China, and not long after that he opened a light manufacturing business. The 1970s saw Samsung enter the chemical and heavy manufacturing industries. In the 1980s, the company entered the aerospace and telecommunications industry. During this decade, Samsung also became a major world supplier of semiconductors.

Samsung Electronics is one of the largest and most profitable South Korean companies, with sales of $106 billion in 2007, $134 billion in 2010, $190 billion in 2014, and $212 billion in 2018. In 2018, Samsung Electronics generated 14 per cent of its total sales from Korea, 18 per cent from China, 17 per cent from Asia and Africa, 34 per cent from America and 18 per cent from Europe. Although it ranks with Panasonic and Hewlett-Packard among the top three global firms in electrical appliances and electronics, it is now the largest electronics firm in the world by some accounts.

The 1997 Asian crisis forced Samsung to switch its focus from cheap consumer electronics to the top end of the market. The firm sold over 100 non-core businesses and let go 30 per cent of its employees, a significant step in a country with traditionally militant trade unions. The refocusing on R&D, design and marketing has since paid off. Driven by its four design centres in London, Tokyo, San Francisco and Seoul, Samsung won more prizes from the Industrial Design Society of

America in 2005 than any other firm. It was world number two in cell phones, and number one in DRAM memory chips, flash memory chips, hard drives and TFT-LCDs. Key innovative products include LED-backlit LCD TVs, Galaxy S cell phones and the Galaxy tablet which rivals the iPad.

Contrasting the route taken by Hyundai Automotive, Samsung Electronics is still part of the Samsung *chaebol*, the largest in South Korea, with businesses ranging from shipbuilding, engineering and chemicals to financial services, hotels and a theme park. The conglomerate is nearly four times larger than its nearest rivals LG and SK and accounts for about one-third of the country's stock market capitalisation. The group is controlled through a complicated web of shareholdings that bind its 27 subsidiaries, although over 60 per cent of Samsung Electronics shares are in the hands of foreign investors.

This opaque structure still worries minority shareholders, who have seen their returns eroded from the widespread *chaebol* practice of using profitable businesses to subsidise weaker affiliates and fund risky expansion. Samsung would arguably be in an even stronger position today had it not been called upon to bail the group out of failed investments in the past, including an attempt to break into the auto sector which lost the group credibility as well as cash.

Website: www.daewoo.com; www.hyundai.com; www.hyundai-motor.com; www.samsung.com; www.samsungelectronics.com; www.seriworld.org

Sources: Jason Leow and Gordon Fairclough, 'Hyundai freshens China effort', *Wall Street Journal*, 8 April 2008; 'As good as it gets? Special report on Samsung Electronics', *The Economist*, 15 January 2005; C. Wright, 'After the crisis, the fight back', *Financial Times*, 1 March 2005, p. 6; A. Ward, 'Hyundai wins 'most reliable' ranking in US', *Financial Times*, 6 September 2004, p. 15; A. Fifield, 'Seoul to clamp down on *chaebol*', *Financial Times*, 1 March 2005, p. 15; A. Fifield and J.-A. Song, 'SK Corp steps up its cautious courtship', *Financial Times*, 1 December 2004, p. 12; Samsung, *Annual Reports*, 2007–14; Thomson Reuters, *OneSource*, 2011; 'The Global Fortune 500', 2011 ranking, *Forbes*, 25 July 2011 issue; Hyundai Motor, *Annual Reports*, 2006–14; http://www.statista.com/statistics/275520/ranking-of-car-manufacturers-based-on-global-sales/; https://data.worldbank.org/indicator/NY.GDP.PCAP.CD?end=1960&locations=KR-GH-

JP&start=1960&view=bar; https://www.samsung.com/global/ir/financial-information/financial-valuation-snapshot/; http://fortune.com/global500/list/filtered?hqcountry=South%20Korea.

Later in this chapter we take a look at the Indian software and IT services industry. Within this industry there are small but significant examples of how success in one particular niche market can support triad access for firms in unrelated sectors. In March 2000 the UK's Tetley Tea Group was acquired by Tata Tea Limited (later it would acquire JLR, among other British firms). Coming more than 50 years after the end of 200 years of British colonial rule that had supported British-owned tea estates in India, this shift of power is an appropriate symbol for the twenty-first century. But the takeover was only made possible because of the financial success of Tata's IT division, Tata Consultancy Services (TCS). Both are part of the Tata Group, one of India's biggest publicly quoted conglomerates. Tata Tea was originally a tea estates company and grew to become India's second most popular tea brand, with a 21 per cent share of the Indian branded teas market, 54 tea estates and 59,000 employees. Senior management at Tata Tea said:

> We wanted to create a global brand, because the marketplace was global and in a global marketplace only global brands survive, local players get marginalized. We did not want to get marginalized, so we had to either build a global brand or acquire one.

At the time TCS was 'Asia's largest global software and services company' (according to its own PR), whose revenues had doubled every two years for six years. TCS was the 'jewel in the crown' of the Tata conglomerate, making net profits of over $489 million in the year of the Tetley acquisition. Over 90 per cent of these revenues came from the firm's software exports, which were double those of its nearest domestic rival. TCS had 11,000 professionals in 50 countries and sold customised software systems, consultancy services and, increasingly, e-business products and

services to a wide range of businesses partly through alliances with Western giants like Microsoft, IBM and Netscape. The revenues and enhanced market capitalisation gained from the software side provided the financial leverage to move up the value chain in the tea industry, taking over a major Western brand to enter into the UK market. This could be described as a case of ‘reverse colonisation’ and there are many more like it to come.[10]

Active learning check

Review your answer to Active Learning Case question 3 and make any changes you like. Then compare your answer to the one below.

3 Why did Acer form strategic alliances with IBM and Texas Instruments?

Acer was not familiar with the North American market and was a new kid on the computer block. So it formed strategic alliances, whenever possible, with the dominant US MNEs. In doing so, Acer learned about the US triad market and how to distribute its products there. It also gained new technological capabilities for both process (manufacturing) innovation and product design and development. Acer was then able to move ahead of these once-dominant US firms once it combined its efficiency in production with its new market knowledge of the rich North American customers.

KEY POINTS

1. Emerging economies are increasingly important for MNEs: as growing markets; as sources of cheaper or better production inputs; and as a source of competitors in the shape of new MNEs as non-triad firms internationalise.
2. Emerging economies tend to be controlled more strongly by their governments and are less predictable and riskier than triad markets.
3. Emerging market countries need investment from, and access to, a triad bloc in order to develop global industries. Inflows and outflows of global FDI show that there is growing integration between countries inside and outside the triad.
4. Past trends such as privatisation, liberalisation and legislative changes that were designed to encourage foreign direct investment (FDI) helped emerging economies to tap their economic potential. Intra- and inter-regional trade agreements were also helpful in both creating mini common markets and smoothing international trade.
5. FDI into Asia is concentrated in the ten fast-growing economies. There is strong intra-regional trade and FDI growth and a marked increase in the importance of service industries; most of the 50 largest non-financial TNCs from developing countries are from the Asia-Pacific region.
6. Despite years of liberalisation, the central and eastern European region attracts relatively small amounts of FDI.
7. Latin America and the Caribbean region receive a small percentage of global FDI (less than China). Intra-regional competition is strong but

political instability still acts as a constraint.

8 Africa receives less than 4 per cent of global FDI and remains relatively unattractive and risky for most investors. South African MNEs are expanding across the region in particular industry sectors.

9 The newly industrialised countries (NICs), a subgroup of non-triad economies, have experienced rapid economic growth and increased trade and FDI, partly by specialising in particular industries and developing comparative and competitive advantages.

10 NICs and other emerging markets in Asia are seen by some to be following the Flying Geese model of economic development. The Indian software industry appears to counter this pattern of sequential industry specialisation as well as contradicting the main tenets of Porter's diamond of competitive advantage.

11 Emerging economies are growing in importance as sources of innovation and as locations for R&D investment by MNEs.

Key terms

- **resource-seeking FDI**
- **market-seeking FDI**
- **liberalisation policies**
- **intra-regional investments**
- **newly industrialised countries (NICs)**
- **Flying Geese model**
- **Korean chaebols**

REVIEW AND DISCUSSION QUESTIONS

1 Why do MNE managers need to develop an understanding of changing economic conditions in non-triad regions?

2 What characteristics do we tend to associate with emerging economies that are important considerations for foreign investors?

3 How have emerging economies liberalised to encourage FDI?

4 How does inward FDI help emerging economies and their domestic industries?

5 Which non-triad regions and countries have achieved the most rapid economic growth in the last 10 to 20 years and what factors have helped their development?

6 Why does Africa receive relatively little inward FDI?

7 What insights does the Flying Geese model of economic development provide for understanding current and future trade and investment flows? What are its weaknesses as a model?

8 How did Indian IT, software and services firms evolve beyond their reliance on cheap labour to develop firm-specific advantages and internationalise?

REAL CASE

The Indian IT, software and services industry

With an average per capita GDP of around $2,041 in 2019, India is a less developed country (LDC). It has low literacy rates and high infant mortality rates. There are just 18 internet users for every 100 people. Yet it also boasts one of the fastest-growing knowledge-based industries in the world.

The Indian IT software and services industry has outstripped all other industries, becoming the largest industry in India in terms of market capitalisation. During the late 1990s it grew by an average of 50 per cent year on year. It is increasingly important to overall GDP and, more significantly, as a contributor to India's exports. Almost 3 million software professionals and a further 6 million people directly and indirectly are employed by the Indian software industry. India controls over 20 per cent of the global customised software market, specialising in high-quality solutions and IT services for corporate customers in the banking, finance and insurance sectors. It is not currently a player in the market for off-the-shelf, packaged software, which is dominated by US firms.

As we know, exports provide a clear indicator of global competitive advantage. Indian software industry exports have grown from under $5 million in 1980 to $700 million in 1996, $6 billion in 2000, $12 billion in 2004, over $30 billion in 2007, over $80 billion in 2014, and to over $125 billion in 2018 (see Figures 19.7 and 19.8). The top firm, Tata Consultancy Services (TCS), a division of the Tata conglomerate, has 424,285 employees and revenues of $20.9 billion as of 2019. As of 2014, the organisation has grown to become the seventh IT service provider in the world. The number two firm, Infosys Technologies, managed 228,123 employees and revenue of $11.8 billion in 2018.

However, the sources of advantage underpinning the growth rate and success of the Indian IT industry are not explained by many of the standard international business frameworks, such as the Porter diamond model. Few, if any, of the factors that led to the genesis of the industry were initially present in India. There was no local demand; related and supporting industries, such as

telecoms and computing, were highly underdeveloped; the national communications infrastructure was among the worst in the world; and the main factor of production, the skills and knowledge of software programmers and IT business managers (an acquired factor endowment), was initially not home-grown.

The industry began with Indians returning from higher education, IT training, and often work experience in the United States and Europe. Many of the industry founders, such as Wipro Chairman Azim Premji, Ramalinga Raju of Satyam and S. Ramadorai of TCS, were educated at US universities (although others, such as F. C. Kohli of TCS and Infosys Chairman Narayana Murthy, were not). They noticed the rising demand for customised software programmers and IT expertise in the banking, insurance, financial services and other industries in the West, and saw India as a potential low-cost provider of this expertise. They returned to India and built firms to meet the software needs of the triad, primarily the United States.

Factors that were on their side were the English language skills of the Indians, as this is the main software programming language; the time difference that allowed a 24-hour software development project cycle; new global information and communications network infrastructures; fears over the Y2K or year 2000 problem; and the low cost of labour. ‘Body shopping’, the contracting of Indian programmers and their physical relocation to work with clients abroad, accounted for 90 per cent of industry revenues in 1989. The average cost of a software programmer in India in the late 1990s was still about one-twelfth the cost of a US or European programmer. But wage rates were relatively much lower in the early stages of the industry’s growth cycle and increased at around 25 per cent per year from the mid-1990s. The cost of a programmer in China or Russia is now around 20 per cent lower than in India, and the same lack of barriers to entry will help firms based in these countries to mount a new competitive threat.

As the industry evolved, government support, particularly the development of software technology parks (the STPI network), the promotion of technical training and subsidies to ICT infrastructure, became important. Also significant were the activities of US and European multinationals. Initially Western firms subcontracted programming and other tasks to Indian firms to exploit the cheap labour advantage. Many, like Texas Instruments, Microsoft and Computer Associates, made substantial investments to build local operations to work within the emerging

industry clusters in Bangalore and Madras. These global firms promoted innovation both as customers and as suppliers to local firms. They transferred hardware and software technology and assisted in the development of local technological capabilities through technical and management training, investment in R&D, new product and services development, and joint ventures. They also prompted and sometimes assisted in the development of local ICT infrastructure.

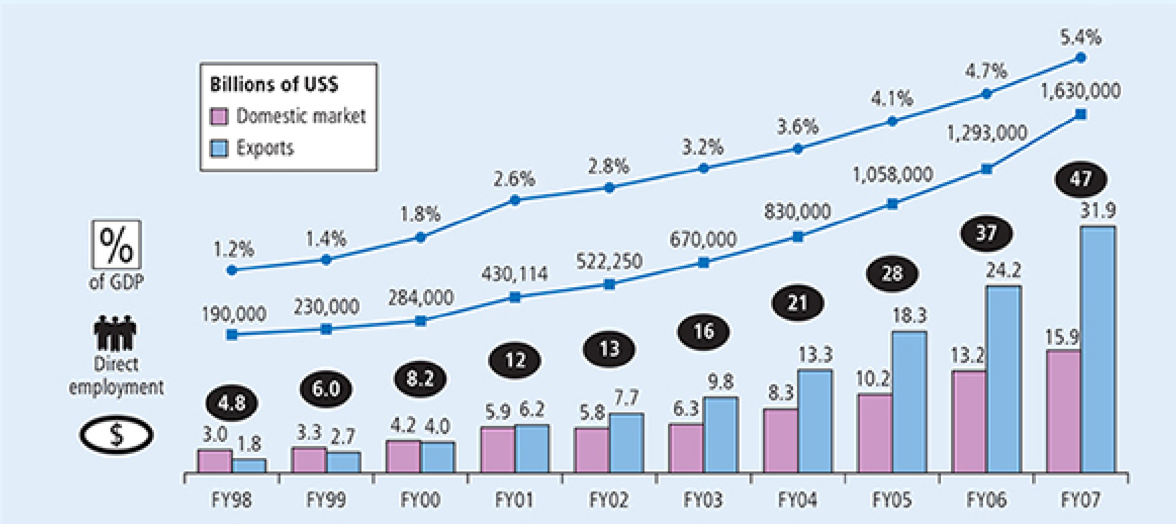

Figure 19.7 **India's IT Industry: rapid growth in the early years**

Source: NASSCOM Report, http://www.nasscom.in.

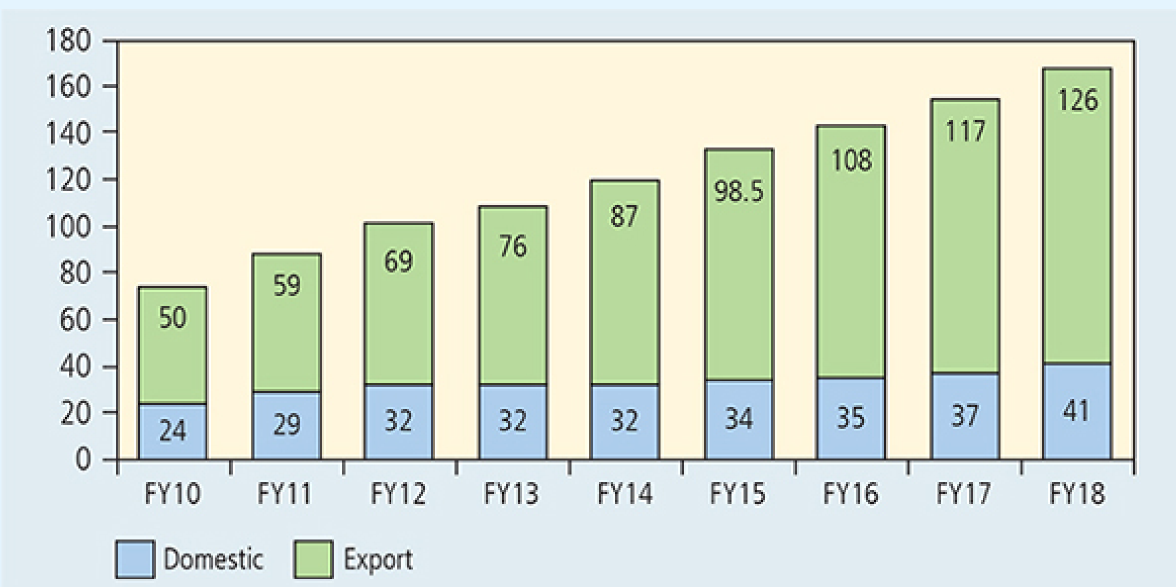

Figure 19.8 **The growth of the Indian IT market: local and global (US$ billion), 2010–18**

Source: https://www.ibef.org/download/IT-ITeS-Report-July-2018.pdf.

Perhaps the most important factor underlying the continued success of the industry is its evolution from an industry based on cheap labour and low costs to one based on value-added expertise, including specialist software and IT systems design and development capabilities. Indian software firms have moved up the value chain, shifting the basis of their competitive advantage from just cost to a combination of cost, quality and high-end R&D expertise. There have been a range of positive effects on the local economy, not least the growth of direct and indirect employment in the sector, as shown in Figure 19.9.

Indian firms are also now themselves actively subcontracting to lower-cost providers in China and elsewhere as they move away from contract programming as a major source of their revenues and into e-commerce and web-related products and services. They are leveraging their advantages in cost and skills through joint ventures with big, established players in the computing, telecom and consumer electronics industries. The Infosys–Microsoft joint venture, focusing on MS .NET products, is an example of this, as is the Mahindra–British Telecom venture. An estimated 300 multinational companies have been engaged in R&D rather than contracting work in India. Intel, Microsoft, Cisco Systems, Samsung Electronics, Oracle, SSA Global, and others have set up R&D activities in Hyderabad, Mumbai and Bangalore.

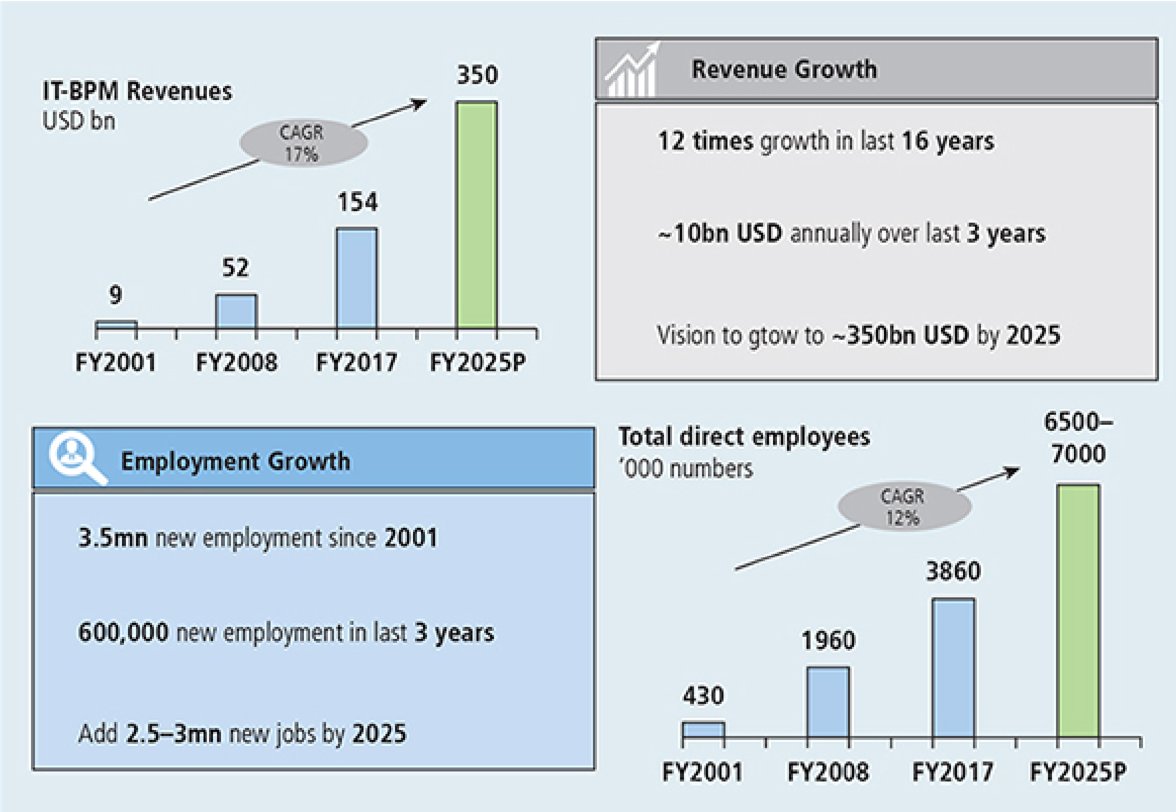

Figure 19.9 The growth of the Indian IT market in terms of revenue and employment

Source: NASSCOM and McKinsey Perspective 2025.

As a result of these developments, the industry has divided into a variety of subsectors (see Figure 19.10). The IT software and services sector is still the largest and the key export revenue earner, but growth has slowed. A domestic software and telecom industry, with a thriving venture capital industry, has also emerged in India. This is evidence of a strong and growing industry cluster that has evolved, unusually, *after* the export success of key firms in the industry. IT-enabled services (ITES) and business process outsourcing (BPO) services, including call centres, transcriptions services and back-office processing such as billing, taxation and accounting, have been growing rapidly. Hubs of these services are Mumbai, Bangalore, Chennai, Kolkata, Hyderabad, Kochi, Ahmedabad and Pune. Some of the key players in this market are AMX, Convergys India Services, GE Capital, Standard Chartered, Dell, Healthscribe India, EXL Service, Daksh eServices, Wipro Spectramind and 24/7 Customer.

The development of the ITES/BPO subsector has brought home some of the threats as well as opportunities of living in a globally connected world for people in Europe and the United States. According to the UK's Communication Workers Union, for example, 33 firms including Barclays, British Airways, Lloyds TSB, Prudential and Reuters have collectively outsourced 52,000 jobs serving UK customers to India. Norwich Union, the UK's largest insurer, has built up a workforce of 3,700 people in India and plans to double this in the near future. This is a sign of the times, and as global firms discover new ways of accessing cheaper and/or better expertise in other parts of the world, some groups of people will experience new opportunities to join and benefit from the global economy while others will feel increasingly vulnerable to the threat of new competition.

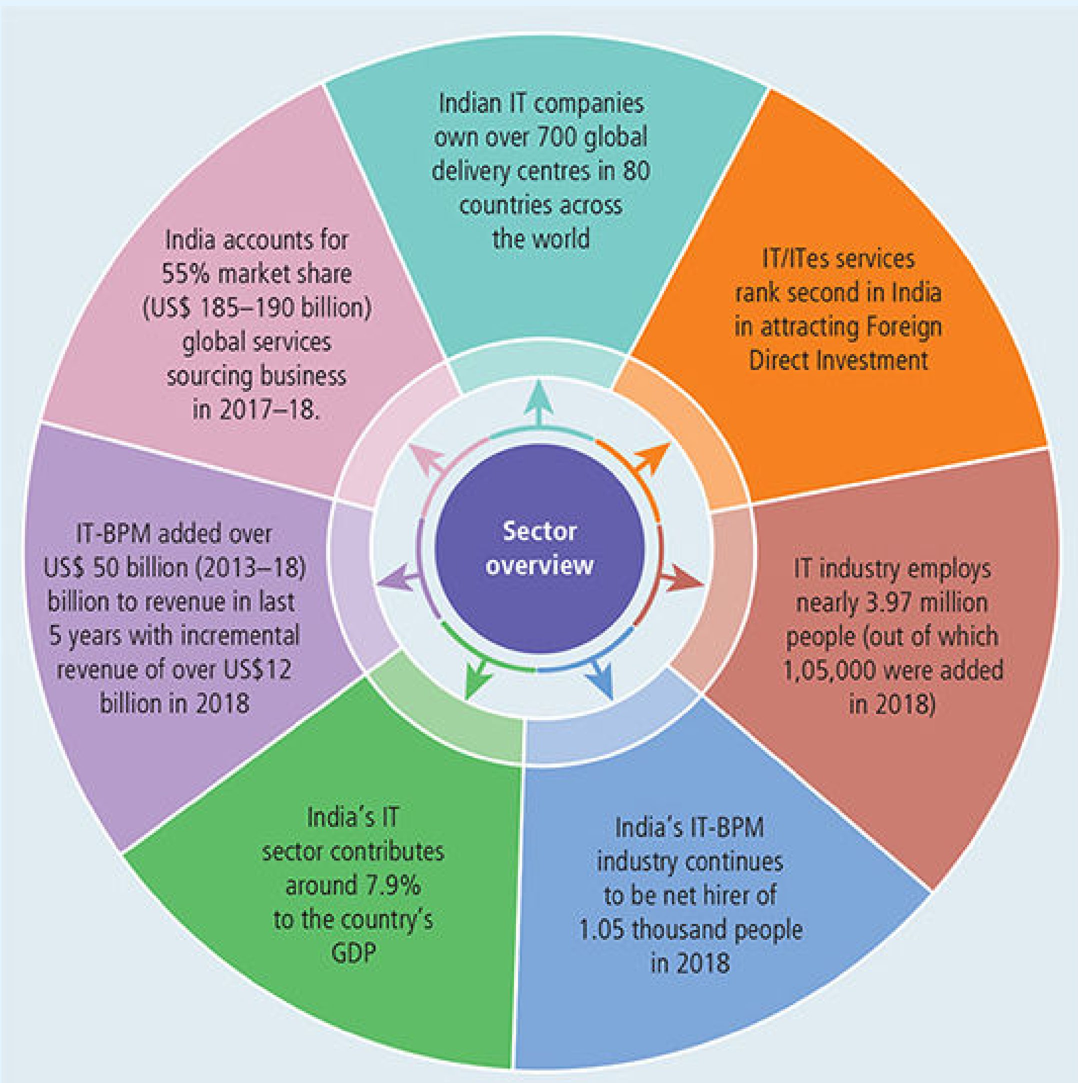

Figure 19.10 India's IT sector overview

Source: https://www.indiaservices.in/it-ites/.

Sources: NASSCOM, *The IT-BPO Sector in India: Strategic Review for 2011*, Executive Summary. NASSCOM, http://www.nasscom.in/upload/Publications/Research/140211/Executive_Summary.pdf; NASSCOM, 'Indian IT/ITES industry: impacting economy and society 2007–08', NASSCOM Foundation Report, 2008; 'Soaring salaries hit India IT group margins', *Financial Times*, 12 September 2007; 'Offshoring pays off for UK companies', *Telegraph*, 25 January 2005; 'India makes it to the global R&D map', *Financial Express*, 6 December 2004; D. Gardner, 'Bangalore-based software company to use US web platform for e-commerce solutions', *Financial Times*, 15 September 2000; K. Merchant, 'Hidden gem seeks share of limelight: information technology', *Financial Times*, 9 August 2000; K. Merchant and D. Gardener, 'New Delhi woos Silicon Valley Indians: IT successes encouraged to invest', *Financial Times*, 15 September 2000; http://indiainfoline.com; http://www.nasscom.in/; http://www.indiainvest.com; https://ict4dblog.wordpress.com/2015/04/28/indian-itsoftware-sector-statistics-1980–2015-time-series-data/; NASSCOM and McKinsey Perspective 2025; https://www.indiaservices.in/it-ites/; https://www.ibef.org/download/IT-ITeS-Report-July-2018.pdf; https://www.tcs.com/content/dam/tcs/investor-relations/financial-statements/2018-19/q4/IFRS/Press%20Release%20-%20USD.pdf; https://www.bizvibe.com/blog/it-solutions-outsourcing/top-10-it-companies-in-the-world/; https://www.infosys.com/investors/reports-filings/quarterly-results/2018-2019/Q4/Documents/fact-sheet.pdf.

1 How well does the Porter diamond framework explain the beginnings of the Indian IT and software services industry?

2 Why has this kind of industry not developed in other parts of the world, where triad companies also outsource IT activities (such as Barbados)?

3 What are the threats and opportunities for Western software firms arising from this shift in the competitive landscape, and how are they strategically responding to these?

REAL CASE

Bumrungrad International in Thailand

Medical tourism (medical travel, health tourism or global healthcare) is not as new as we might think. Spa towns and sanatoriums promoted international travel for health reasons across Europe and beyond, from the eighteenth century onwards. But the industry has entered a new phase as a globally competitive business worth an estimated $65–$87.5 billion in 2018, which is based on approximately 20–24 million cross-border patients worldwide. Levels of quality, safety and reliability in locations beyond the triad are now good enough to create choice for patient–customers and for price to become a key factor. As Table 19.4 shows, there is a clear economic incentive for private and public healthcare clients to 'shop around'.

The growing costs of employer healthcare schemes in the United States are one reason for the growing popularity of medical tourism. Canada and Mexico have developed thriving businesses based on their proximity to the US market. A few US employers have also begun to build incentives into their benefit packages to encourage employees to travel abroad for healthcare. This includes paying for travel and subsistence for time away from work in return for cheaper medical bills. The Maine-based retailer Hannaford Brothers, for example, will cover the total costs for employees to travel to Singapore for knee and hip replacements, including travel for a companion accompanying the patient. Cuba attracts 20,000 medical tourists per year, but for obvious reasons these have come from Latin America and Europe rather than the United States.

Source: Apples Eyes Studio/Shutterstock

There are, of course, added risks for many people in venturing beyond their borders in search of low-cost medical procedures. These can be exacerbated by the legal complexities of extending insurance cover across borders. In an attempt to alleviate some of the risk and uncertainty, international healthcare accreditation, offered by organisations like the US-based Joint Commission International (JCI) and the associated Society for International Healthcare Accreditation (SOFIHA), is increasingly important.

There are also ethical issues beyond the economics of supply and demand, not least the problem that wealthy medical tourists divert scarce medical resources and expertise away from the poorest and neediest in developing countries. Massive investments in initiatives like the 'Medicity' project in the Gurgaon region near New Delhi focus on providing top-class healthcare for the rich, in the world's poorest areas. Supporters cite the multiplier effect of medical clusters, which include employment and subsequent investment in local people and infrastructure. Critics simply see a further widening of global income and welfare disparities.

Table 19.4 Comparing the international costs of medical procedures

Medical procedure	Cost in the US* ($)	Cost in alternative locations ($)
Heart-valve replacement	200,000	10,000 (India) including airfare and vacation
Coronary artery bypass surgery	100,000	12,000 (Bumrungrad Hospital, Thailand)
Full facelift	20,000	1,250 (South Africa); can be part of a 'medical safari'
Knee replacement	15,000	5,000 (Colombia); including costs of hospital stay
In vitro fertilisation	12,000	5,000 (Panama)

Dental bridge	5,500	500 (India)
Lasik eye surgery	3,700	730 (India and elsewhere)
Colonoscopy	900	640 (Bumrungrad Hospital, Thailand)
Root canal	800	300 (Panama)

* For most examples these are listed as the minimum cost in US hospitals.

Sources: Various.

Bumrungrad International

David Boucher, a 49-year-old American, chose to have a colonoscopy at Bumrungrad International Hospital in Bangkok. His company gladly paid the $640 bill, saving over $250 on the costs of the same procedure in the United States. What is significant is that David Boucher was an assistant vice president of healthcare services at Blue Cross & Blue Shield of South Carolina. His firm is part of the largest group provider of healthcare insurance services in the United States, providing coverage for more than 100 million people. His main reason for undergoing the procedure in Thailand was to advertise the increasingly international options open to his firm’s 1.5 million customers. He has been involved in signing a range of alliances with overseas hospitals and in discussions with local corporations and employee groups about this strategic response to the growing costs of healthcare in the United States. In 2008 Blue Cross took the initiative in medical ‘offshoring’ by creating a partnership with Bumrungrad Hospital through its Companion Global Healthcare subsidiary.

Bumrungrad (‘care for the people’) International was founded in 1980 and advertises itself as the largest private hospital in Southeast Asia. In 2010 it had 34 outpatient clinics, which included 250 examination rooms with the capacity to service of over 4,000 patients per day. By 2018 it had grown to have a workforce of over 4,800 employees, achieving a turnover of about $593 million. It had 580 beds and over 30 specialised treatment centres, serving around 5,500 patients each day. Over half of its patients are international and come from over 200 different countries. Bumrungrad is a publicly traded company listed on the Thai Stock Exchange. The majority shareholders are Bangkok Bank PCL and the Sophonpanich family.

Several key factors explain Bumrungrad's success. The country has a history of prioritising healthcare perhaps dating back to Prince Mahidol of Songkla, who gained an MD degree from Harvard Medical School in the early twentieth century. Ongoing support from the Thai government and members of the country's ruling elite has made medicine and healthcare a national priority. The founders of Bumrungrad Hospital have focused on service quality and international credibility partly through their recruitment and incentives practices and by aiming for recognised accreditation. The hospital has more than 200 surgeons who are board-certified in the United States and it was the first hospital in Asia to be accredited by the US-based Joint Commission International (JCI).

To counter any potential criticism over the ethics of diverting medical resources to a top-class, but relatively expensive (for locals) hospital, the Bumrungrad Hospital Foundation was established in 1990. It helps the less privileged in Thailand gain access to free medical treatment and healthcare services. The Foundation has provided free medical help to over 100,000 Thais, including 122 paediatric heart operations.

Sources: Laurie McGinley, 'Health matters: the next wave of medical tourists might include you', *Wall Street Journal*, 16 February 2008; Bruce Einhorn, 'Outsourcing the patients', *Business Week*, 13 March 2008; Rory Carroll, 'First World results on a Third World budget', *Guardian*, 12 September 2007; http://www.bumrungrad.com (accessed 2016); http://www.patientsbeyondborders.com/hospital/bumrungrad-international-hospital (2016); Thomson Reuters, *OneSource*, 2011; https://patientsbeyondborders.com/medical-tourism-statistics-facts; Bumrungrad Annual Report 2018.

1 How is the growing provision of alternative sources of health services around the world likely to affect the triad-based providers, public and private?

2 Explain the rise of Bumrungrad International and the Thai medical tourism industry in terms of country-specific advantages (CSAs) and firm-specific advantages (FSAs).

3 Should healthcare 'offshoring' be viewed or treated any differently from any other globalising industry, such as software or BPO services?

NOTES

1 Emerging market and developing country economies overall have grown by an average of over 6.5 per cent in recent years, which is much faster than historical trends and much faster than developed economies. For the most recent data see: www.unctad.org who produce the annual World Development Report.
2 See http://www.telefonica.es/accionistaseinversores/
3 For further discussion see S. C. Collinson, 'M&A as imperialism?', in D. Angwin (ed.), *Images of M&A* (Oxford: Blackwell, 2006).
4 Adam Smith, *The Wealth of Nations*, Book IV: 2, Modern Library edition, 1776.
5 K. Akamatsu, 'Historical patterns of economic growth in developing countries', *The Developing Economies*, vol. 1 (1962), pp. 3–25; Kálmán Kalotay, 'The European flying geese: new FDI patterns for the old continent?' *Research in International Business and Finance*, vol. 18, no. 1 (2004), pp. 27–49. For other analyses, at the industry and firm levels, see L. Kim, 'Crisis construction and organizational learning: capability building in catching-up at Hyundai Motor', *Organization Science*, vol. 9 (1998), pp. 506–21; F. J. Contractor (ed.), *Economic Transformation in Emerging Countries: The Role of Investment, Trade and Finance* (Oxford: Elsevier, 1998); Michael Hobday, *Innovation in East Asia: The Challenge to Japan* (Aldershot: Edward Elgar, 1995); Sanjaya Lall, *Learning from the Asian Tigers: Studies in Technology and Industrial Policy* (Basingstoke: Macmillan, 1996); Dosi Giovanni et al., *The Economics of Technical Change and International Trade* (Hemel Hempstead: Harvester Wheatsheaf, 1990); Kim Linsu,

Imitation to Innovation: The Dynamics of Korea's Technological Learning (Boston, MA: Harvard Business School Press, 1997).

6 Raymond Vernon, 'International investment and international trade in the product cycle', *Quarterly Journal of Economics* (May 1996), pp. 190–207.

7 See the references in note 9 below, and Linsu Kim and Richard R. Nelson, *Technology, Learning and Innovation: Experiences of Newly Industrialising Economies* (Cambridge: Cambridge University Press, 2000).

8 This was one of Porter's original examples from the study of factors underlying export success in particular industries in particular economies which are summarised in the 'diamond of advantage'. Michael E. Porter, *The Competitive Advantage of Nations* (New York: Free Press, 1998). More recent research shows how the overdependence on CSAs by some Japanese firms has led to an inability to adapt and internationalise in response to changing domestic economic conditions; S. Collinson and A. M. Rugman, 'The regional nature of Japanese multinational business', *Journal of International Business Studies*, vol. 39, no. 2 (2008), pp. 215–30.

9 See the *World Competitiveness Report* and discussions about the Innovation Capacity indicators at www.weforum.org

10 See Collinson, 'M&A as imperialism?'; K. Merchant, 'Hidden gem seeks share of limelight: information technology', *Financial Times*, 9 August 2000

BIBLIOGRAPHY

Aybar, Bülent and Ficici, Aysun. 'Cross-border acquisitions and firm value: an analysis of emerging-market multinationals', *Journal of International Business Studies*, vol. 40 (October/November 2009).

Bound, Kirsten, Leadbeater, Charles, O'Connor, Simon, Webb, Molly and Wilsdon, James. *The Atlas of Ideas: Europe and Asia in the New Geography of Science* (London: DEMOS, 2007), http://www.demos.co.uk

Buckley, Peter J., Chen, Liang, Clegg, L. Jeremy and Voss, Hinrich. 'Risk propensity in the foreign direct investment location decision of emerging multinationals', *Journal of International Business Studies*, vol. 49, no. 2 (2018).

Casanova, Lourdes. *Global Latinas: Latin America's Emerging Multinationals* (New York: Palgrave Macmillan, 2009).

Christensen, Clayton M., Hang, Chang-Chieh, Chai, Kah-Hin and Subramanian, Annapoornima M. 'Editorial: managing innovation in emerging economies: an introduction to the special issue', *IEEE Transactions on Engineering Management*, vol. 57, no. 1 (February 2010).

Corredoira, Rafael A. and McDermott, Gerald A. 'Adaptation, bridging and firm upgrading: how non-market institutions and MNCs facilitate knowledge recombination in emerging markets', *Journal of International Business Studies*, vol. 45, no. 6 (2014).

Filatotchev, Igor, Strange, Roger, Piesse, Jenifer and Lien, Yung-Chih. 'FDI by firms from newly industrialised economies in emerging

markets: corporate governance, entry mode, and location', *Journal of International Business Studies*, vol. 38, no. 4 (July 2007).

Filippaios, Fragkiskos, Annan-Diab, Fatima, Hermidas, Amir and Theodoraki, Charikleia. 'Political governance, civil liberties, and human capital: Evaluating their effect on foreign direct investment in emerging and developing economies', *Journal of International Business Studies* (2019).

Friedman, Thomas L. *The World Is Flat: A Brief History of the Twenty-first Century* (New York: Farrar, Straus, & Giroux, 2005).

Gaffney, Nolan, Karst, Rusty and Clampit, Jack. 'Emerging market MNE cross-border acquisition equity participation: the role of economic and knowledge distance', *International Business Review*, vol. 25, no. 1 (2016).

Giuliani, Elisa, et al. 'Emerging versus advanced country MNEs investing in Europe: a typology of subsidiary global–local connections', *International Business Review*, vol. 23, no. 4 (2014).

Goldstein, Andrea. *Multinational Companies from Emerging Economies: Composition, Conceptualization and Direction in the Global Economy* (New York: Palgrave Macmillan, 2nd edn, 2009).

Hamm, Steve, *Bangalore Tiger* (New York: McGraw-Hill, 2006).

Huang, Kenneth G. and Li, Jiatao. 'Adopting knowledge from reverse innovations? Transnational patents and signaling from an emerging economy', *Journal of International Business Studies* (2017).

Kotabe, Masaaki and Kothari, Tanvi. 'Emerging market multinational companies' evolutionary paths to building a competitive advantage from emerging markets to developed countries', *Journal of World Business*, vol. 51, no. 5 (2016).

Kumar, Sameer, Jamieson, Jacky and Sweetman, Mathew. 'Software industry in the fastest emerging market: challenges and opportunities',

International Journal of Technology Management, vol. 29, no. 3/4 (2005).
Li, Ming Hua, Cui, Lin and Lu, Jiangyong. ‘Varieties in state capitalism: outward FDI strategies of central and local state-owned enterprises from emerging economy countries’, *Journal of International Business Studies*, vol. 45, no. 8 (2014).
Li, Peter Ping, ‘Toward a learning-based view of internationalization: the accelerated trajectories of cross-border learning for latecomers’, *Journal of International Management*, vol. 16, no. 1 (March 2010).
Luo, Yadong and Bu, Juan. ‘How valuable is information and communication technology? A study of emerging economy enterprises’, *Journal of World Business*, vol. 51, no. 2 (2016).
Marano, Valentina, Tashman, Peter and Kostova, Tatiana. ‘Escaping the iron cage: Liabilities of origin and CSR reporting of emerging market multinational enterprises’, *Journal of International Business Studies*, vol. 48, no. 3 (2017).
McManus, John, Li, Mingzhi and Moitra, Deependra. *China and India: Opportunities and Threats for the Global Software Industry* (Oxford: Chandos, 2007).
Meyer, Klaus E. and Peng, Mike W. ‘Theoretical foundations of emerging economy business research’, *Journal of International Business Studies*, vol. 47 (2015).
Nguyen, Quyen T. K. and Rugman, Alan M. ‘Internal equity financing and the performance of multinational subsidiaries in emerging economies’, *Journal of International Business Studies*, vol.46 (2014).
Panicker, Vidya Sukumara, Mitra, Sumit and Upadhyayula, Rajesh Srinivas. ‘Institutional investors and international investments in emerging economy firms: A behavioral risk perspective’, *Journal of World Business*, vol. 54, no. 4 (2019).

Prahalad, C. K. *The Fortune at the Bottom of the Pyramid* (Upper Saddle River, NJ: Wharton School/Pearson, 2005).

Prestowitz, Clyde. *Three Billion New Capitalists: The Great Shift of Wealth and Power to the East* (London: Basic Books, 2006).

Puffer, Sheila M. and McCarthy, Daniel J. 'Can Russia's state managed, network capitalism be competitive? Institutional pull versus institutional push', *Journal of World Business*, vol. 42, no. 1 (March 2007).

Ramamurti, Ravi and Singh, Jitendra V. (eds.) *Emerging Multinationals in Emerging Markets* (Cambridge: Cambridge University Press, 2010).

Rugman, Alan M. 'How global are TNCs from emerging markets?' in Karl Sauvant (ed.), *The Rise of Transnational Corporations from Emerging Markets: Threat or Opportunity* (Cheltenham: Edward Elgar, 2008).

Rugman, Alan M. 'Globalization, regional multinationals and Asian economic development', *Asian Business and Management*, vol. 9, no. 3 (September 2010).

Rugman, Alan M. and Collinson, Simon. 'The regional character of Asian multinational enterprises', *Asia Pacific Journal of Management*, vol. 24, no. 4 (2007).

Rugman, Alan M. and Oh, Chang Hoon. 'Korea's multinationals in a regional world', *Journal of World Business*, vol. 43, no. 1 (January 2008).

Sanfilippo, Marco. 'FDI from emerging markets and the productivity gap: an analysis on affiliates of BRICS EMNEs in Europe', *International Business Review*, vol. 24, no. 4 (2015).

Sartor, Michael A. and Beamish, Paul W. 'Offshoring innovation to emerging markets: organizational control and informal institutional distance', *Journal of International Business Studies*, vol. 45 (2014).

Sukpanich, Nessara and Rugman, Alan M. 'Multinationals and the international competitiveness of ASEAN firms.' In Philippe Gugler

Julien Chaisse (eds.), *Competitiveness of the ASEAN Countries, Corporate and Regulatory Drivers* (Cheltenham: Edward Elgar, 2010).

Zhao, Meng, Park, Seung Ho and Zhou, Nan. 'MNC strategy and social adaptation in emerging markets', *Journal of International Business Studies*, vol. 45 (2014).

WWW RESOURCES

http://www.tdctrade.com

http://www.lanic.utexas.edu

http://www.africaguide.com

Chapter 20

CHINA

Contents

Objectives of the chapter

In the 1950s China's economy was the size of Sudan's. Now, following many decades of liberalisation, it is the second largest economy in the world. Political change has led to economic

and social change, which in turn is driving further political change and increasingly turbulent interdependencies with other parts of the globe. Rapid economic growth has led to an expanding domestic consumer market alongside continued poverty and growing disparities in wealth and income across the population of over 1.4 billion people.

The scale, scope and speed of these changes are unprecedented and the resulting range of commercial and competitive opportunities and threats should be of interest to every manager and every firm worldwide. In this sense China's rise represents a major test of adaptability for firms looking to break into its growing domestic market and for those defending home markets against Chinese imports and FDI. In order to survive, many firms need to understand the evolving strengths and weaknesses of Chinese businesses, identify the resulting complementarities and competitive conflicts, and reposition themselves accordingly.

The specific objectives of this chapter are to:

1. *Understand* the nature of the Chinese economy, the role of government and the characteristics of China's domestic market and its corporations.
2. *Examine* the opportunities and constraints facing Western firms investing in China and the ways in which successful firms have adapted to succeed there.
3. *Analyse* the degree to which Chinese firms are internationalising, how and where they are selling and/or investing abroad, and what kinds of relative competitive advantages they appear to have.
4. *Reflect* on the implications of China's rise, in 'real-world' terms and for academic analysis and understanding of firm performance and business processes.

ACTIVE LEARNING CASE

Oxford Instruments in China

The Oxford of ancient spires and ivory towers is well known among the Chinese. The successful, high-tech spin-off Oxford Instruments (OI) is less well known, but the company has worked to change this. Having sold a range of its products in China for over 10 years and experienced a 30 to 40 per cent growth in sales year after year, senior managers at OI decided it was time to invest more heavily. The company opened representative offices in Beijing and Shanghai during the last decade and employed 20 people (including two expatriates). Then, between April 2003 and August 2004, OI registered as a **wholly foreign-owned enterprise (WFOE)** and established a manufacturing facility. This was a major investment for a medium-sized firm with a limited turnover. But it was a necessary step given that over 90 per cent of OI's sales were from outside the UK, with approximately 10 per cent in China. Moreover, its managers learned a number of important lessons along the way.

A key reason for investing directly in the Chinese market, moving to a higher level of both commitment and risk, was to get closer to the growing number of Chinese customers. OI chose to build on the strong platform of representative offices through the establishment of a repair and service centre for supporting its microanalysis detector customers in China. It also wanted to provide a platform for the assembly of top-level products. To establish a business entity capable of delivering these kinds of activities, it needed some outside help. One way to reduce the risks of FDI is to hire local specialists who know about the local rules of the game and with the relationships and connections to help smooth the way. Another route is to hire experts who understand the international legal and regulatory conditions relating to an FDI project. In fact, when initiating its investment plans in China, OI did both. An international law firm was hired to ensure that global regulatory standards were followed. A local sponsor was also brought in (at a significantly lower cost) to help with the submission of the investment application to government authorities.

The establishment process itself was relatively straightforward. Step 1 was to register the company name. Step 2 was the submission of a feasibility report and articles of association to show

the firm would be profitable and (most important) produce good tax returns. The WFOE, Oxford Instruments (Shanghai) Co., Ltd., was then given government approval and granted a trading license around three months after the start of the process. Post-registration procedures, including securing the 'red' **company chop** (an official company seal or signature stamp), took a little longer.

Further development of an effective and efficient HQ–subsidiary organisation structure and good working relationships between head-office management and local managers in China were seen to be key priorities in the early stages of the China venture. The UK side defined a common internal financial reporting structure and shared the group business strategy, which the senior management in China was then allowed to revise and tailor to the local context and culture. The existing OI China chief representative, a Chinese national employed by OI for five years, was named as the general manager of the new organisation. The leadership of this existing member of the OI team, with experience of working both in a related industry and in an English-speaking environment, to head up the China operation was important for creating the necessary HQ–subsidiary relationships. As with any international expansion, an overarching question for OI was (and continues to be): what business processes and decision-making responsibilities do we move to China and what do we keep in the UK?

Key constraints and challenges cited by OI include time- and resource-consuming Chinese bureaucracy at various levels, including central, regional and local governments, and individual firms (one customer required 11 different VAT invoices for a single sale). It was important for OI to link the new Shanghai facility into its global IT infrastructure, but the instability of the local internet required the company to invest in alternative (and more expensive) connection methods. As OI continues to grow in China, the task of developing the necessary range of capable, experienced local managers in the sales and marketing functions as well as in operations will continue to be a focus.

Source: Simon Collinson

Perhaps more significant than these problems have been OI's concerns about protecting its intellectual property rights (IPR) in China. OI's R&D assets and technological capabilities underpin its primary competitive advantage. It has had to take steps to avoid losing these to local Chinese competitors. Some formal protection and registration steps are available, and these have been taken by OI, but this provides limited protection in China. More effective protection of IP is gained through placing an emphasis on the careful recruitment of staff in China and the retention of the development and some manufacturing of key technologies at home in the UK. OI's customers are mainly top universities and organisations with high-level scientific research requirements. These customers are often co-developers of new technologies, so OI has built a range of cooperative alliances in which mutual trust and reciprocity are essential.

Many people talk about the importance of relationships in China. One interpretation is that in the process of developing relationships the Chinese are effectively performing a 'credit check'. In the absence of stable or reliable formal contracting rules, regulations, processes and institutions, more emphasis is placed on interpersonal trust as the reliable basis for doing business. What rules

there are in China tend not to be applied consistently. This leaves plenty of scope for influencing processes and decisions, which places even more of a premium on having the right connections.

At an early stage in the project, the following light-hearted ‘rules’ for doing business in China were presented by a speaker at a ‘Making it in China’ session at the University of Cambridge:

> *Rule 1:* China is a highly-regulated country, in which one needs to learn, understand, and follow countless regulations.
>
> *Rule 2:* China presents a chaotic and unpredictable operating environment in which anything is possible; in fact, there are no rules.
>
> *Rule 3:* Rules 1 and 2 are simultaneously valid.

Understanding these local rules of the game has clearly paid off for OI. In 2008 the company won the UK Exporter of the Year Award ‘for the company demonstrating the utmost energy, novelty, patience and persistence, in the field of exports from UK to China during the year’. It has achieved an average annual growth of 50 per cent of export sales to China. From its original Beijing office it has expanded to Shanghai (where it also has a customer support centre), Guangzhou and Chengdu. China has become the fastest-growing market for OI across the world. From annual sales of less than $1 million in 1997, annual sales to China in 2018 exceeded over $60 million. China is the second largest market for the firm; the largest market is the US where the organisation acquired approximately $115 million in revenues. Moreover, the company overall employs over 2,300 people in over 15 countries and earns annual revenues of around $380 million in 2018.

Website: http://www.oxford-instruments.com

Sources: Oxford Instruments, Annual Report, 2010–18; Thomson Reuters, One-Source, 2011. This case has been partly compiled by the authors from a presentation by and discussions with Daniel Ayres, the project manager for the establishment of the manufacturing WFOE in Shanghai. Our sincere thanks to him and Oxford Instruments for allowing us to use the case here.

1. **Why has OI invested in China? In what ways does its strategy fit with current trends in China?**
2. **Which 'mode of entry' did OI select in China and what kinds of operational and practical challenges did it face?**
3. **What kinds of threats and opportunities might OI face from new multinational firms from China and what strategic responses should it be considering?**

INTRODUCTION

With over 1.4 billion people, China (see Figure 20.1) has the largest population in the world, more than Latin America and Sub-Saharan Africa combined. Although it is an ancient civilisation, the economy was only recently liberalised and opened up to trade and investment following Prime Minister Deng Xiaoping's reforms in 1978. Since then it has been moving from a closed centrally planned communist state towards an open market economy, and is increasingly participating as a major player in the modern world. While the rest of the world increasingly relies on China's economic growth to maintain global economic momentum, China itself is feeling the political and social strains of this unprecedented era of change. Its burgeoning economy attracts growing amounts of FDI as foreign firms take advantage of opportunities to produce products cheaper and sell into its expanding domestic market. Chinese firms are also evolving to compete not just in their own market but also abroad, as a new group of multinationals flexes home-grown advantages beyond the 'middle kingdom'.

Figure 20.1 South and East Asia

UNPRECEDENTED SCALE, SCOPE AND SPEED OF GROWTH

Lists of facts and figures that highlight the China phenomenon abound. It is the second largest economy, vying with the United States for the top spot in terms of trade and FDI, the largest producer of rice, wheat, cotton and tobacco, red meat, coal and aluminium. It has over $3 trillion in foreign reserves (by far the largest in the world), 160 cities with more than 1 million people, the largest number of atheists of any country and over 1.25 billion subscribers to wireless phone services. It accounts for over 35 per cent of the world's luxury goods, and manufactures over 70 per cent of the world's toys and over half of the world's bicycles, motorcycles, shoes and mobile phones (its own mob market is worth over $220 billion). It also produces over 30 per cent of the world's coal, but reports 80 per cent of worldwide deaths related to coal mining.

A particular boost came in 2001 when China joined the World Trade Organization (WTO) and began to attract record levels of FDI. **WTO accession** carried with it the commitment to phase out non-tariff barriers, provide trading rights to foreign companies and change conditions on foreign investment, and this has been happening.[1]

The results have been impressive. GDP grew at an average of 8 per cent per year, reminiscent of Japan's 'catching-up' period in the 1960s and 1970s. Up until 2011, China achieved annual growth rates close to 10 per cent; however, since 2011 annual growth levels have been steadily declining (see Table 20.1). Exports and imports, as well as FDI, have surged but with a positive imbalance (exports exceeding imports) resulting in growing foreign reserves and contributing in particular to the massive deficit of the United

States. China is now ranked as the second largest economy in nominal GDP terms and second largest in PPP terms.

The new era of export-led growth has resulted in economic and social development nationally, with a significant overall reduction in poverty across the whole of China (adjusted for purchasing power, China has grown to be over 70 per cent richer than India). But growth has been concentrated in the industrialised east and in urban areas, where per capita disposable income is more than three times higher than that in the rural areas and has grown much faster.

Trade and FDI are major indicators of the level to which an economy is integrated in the global economy and interdependent with other economies. The liberalisation process in China centred on opening up the country in terms of inward and outward trade and FDI. In 2009, the global economic downturn reduced foreign demand for Chinese exports for the first time in many years, but China rebounded quickly, outperforming all other major economies in the years following this dip, with GDP growth around 10 per cent. China's external trade has reached levels of almost 40 per cent of GDP, but it is important to note that over 50 per cent of these exports have come in the past from foreign-owned or foreign-invested firms (see Table 20.2).

The Chinese government's twelfth five-year plan, adopted in March 2011, pledged to continue reforming the economy and emphasised the need to increase domestic consumption in order to make the economy less dependent on exports for GDP growth in the future. The thirteenth five-year plan (2016–20) continued this trend, but also included a new range of environmental sustainability targets, such as the aim to increase the share of non-fossil fuel energy to 15 per cent by 2020.

Table 20.1 China: key economic indicators, 2010–17

	2010	2011	2012	2013	2014	2015	2016	2017
GNI PPP (current international $ trillion)	12.428	13.828	15.307	16.687	18.416	19.797	21.365	23.290
GDP growth (annual %)	10.6	9.5	7.9	7.8	7.3	6.9	6.7	6.9
Inflation GDP deflator (annual %)	6.9	8.2	2.4	2.2	0.8	0.1	1.1	4.1
Current account balance (% of GDP)	3.90	1.80	2.52	1.54	2.25	2.75	1.81	1.35
Unemployment, total (% of total labour force) (modelled ILO estimate)	4.10	4.10	4.10	4.05	4.09	4.61	4.65	4.68

Source: https://databank.worldbank.org/reports.aspx?source=2&country=CHN#.

Table 20.2 China: key trade indicators (2019)

Major exports	% of total	Major imports	% of total
Capital goods	45.2	Capital goods	40.6
Consumer goods	36.4	Raw material	24.1
Intermediate goods	16.3	Intermediate goods	21.5
Raw materials	1.8	Consumer goods	13.0
Leading markets	**% of total**	**Leading suppliers**	**% of total**
US	19.0	South Korea	9.6
Hong Kong	12.3	Japan	9.0
Japan	6.1	Asia (nes)	8.5
South Korea	4.5	US	8.4
Vietnam	3.2	China	7.2

Source: https://unctad.org/en/Pages/DIAE/World%20Investment%20Report/Annex-Tables.aspx (2019).

China faces a number of economic problems, including inflation and local government debt, which swelled as a result of stimulus policies, and is largely off-the-books and potentially of low quality. The 'middle income trap' is also a significant concern, whereby the economy becomes locked into a dependence on low-cost production and low-cost services, which support low-added-value jobs and therefore relatively low incomes. This cycle of low-value demand and supply can evolve into an economic 'catch-22'.[2]

China differs considerably from Japan, during its rapid economic growth phase, in this respect. So, while exports are normally seen as an indicator of local competitive advantage, this is not so straightforward in the case of China. Location endowments certainly convey some specific advantages,

notably the lower costs of manufacturing that result from the availability of cheap labour. It is clear that the liberalisation process has allowed foreign multinationals access to this resource and, certainly in some industries, they are better equipped than local 'infant' industry firms to leverage this advantage. So, a significant proportion of China's export boom has been driven by foreign firms 'migrating' existing manufacturing facilities from elsewhere into China and gaining the benefits of lower-cost exports to existing markets in the triad regions.

The attractiveness of China to MNEs, and the scale of their involvement, are shown by the sheer volume of FDI inflows over the past 20 years (see Table 20.3). In 2017, China recorded over US$132 thousand billion of FDI inflows (many times higher than that of Japan, which has always attracted relatively low amounts of direct investment). China's total stock of FDI is more than four times that for Japan, again despite its relatively recent economic liberalisation. The section below will discuss inward investment into China, followed by a review of the constraints facing firms trying to get into its growing domestic market.

Other firms are benefiting, without investing significantly in China, by extending their supply chains to take advantage of low-cost suppliers. At one point in the mid-2000s Walmart imported over $25 billion in one year from China, making it the sixth largest importer of any 'economy', with a larger volume than that of Russia. Walmart's import volume has since decreased and it is beginning to redress the trade imbalance in a small way by expanding its network of retail stores in China. (See **Real Case: Job losses and offshoring to China**.)

Outward FDI from China has grown significantly in recent years (see Table 20.3), partly as a result of the strong government push for international expansion (the 'Going Global' strategy pursued by MOFCOM and President Xi's 'Belt and Road Initiative' more recently, see below) and the rising use

of mergers and acquisitions (M&As) by Chinese firms to access Western markets, technologies and brands. The final section in this chapter will examine a new breed of Chinese multinational firm.

Table 20.3 China: direct investment flows, outward and inward (billions of US$), 2013-17

	Outward FDI flows					Inward FDI flows				
	2013	2014	2015	2016	2017	2013	2014	2015	2016	2017
China	101,000	123,120	145,667	196,149	124,630	123,911	128,500	135,610	133,710	136,320
India	1,679	11,783	7,572	5,072	11,304	28,199	34,582	44,064	44,481	39,916
United States	328,343	294,754	262,569	280,682	342,269	230,768	201,734	465,765	457,126	275,381
East Asia	225,254	288,750	255,285	302,724	250,226	221,450	257,480	317,755	269,778	264,515
Asia and Oceania	336,368	413,358	359,765	386,097	351,369	430,671	462,248	518,166	477,270	477,549
Developing economies	380,784	457,994	406,237	406,668	380,775	670,790	685,292	744,032	670,158	670,658
World*	1,305,910	1,262,007	1,621,890	1,473,283	1,429,972	1,467,233	1,338,532	1,921,306	1,867,533	1,429,807

Source: UNCTAD, World Investment Report, 2011–18.

Notes: * Excluding Caribbean offshore financial centres.

THE ROLE OF GOVERNMENT

China has evolved from a closed, centrally planned system towards an open, market-oriented economy. Reforms started in the late 1970s with the phasing out of collectivised agriculture, and expanded to include the gradual liberalisation of prices, fiscal decentralisation, increased autonomy for state enterprises, the foundation of a diversified banking system, the development of stock markets, the rapid growth of the non-state sector, and opening up to foreign trade and investment.

Government reforms and the maintenance of the critical balance between liberalisation and continued government control, guiding the development of capitalist enterprises and market incentives, are major factors responsible for the economic success currently experienced by China. They will continue to be critical factors for the sustainability of growth and development, as both the domestic and international contexts become increasingly turbulent. Comparisons between China and Russia are common and can be instructive. One study characterises the differences as follows:

> China gave priority to administrative reform, aligned bureaucratic incentives at all levels with growth and development objectives, and enhanced enterprise and local autonomy while preserving the capacity of the center to exercise control. This approach transformed government bodies into real owners of the reform process and led to privatization over time that was largely welfare enhancing. Russia, on the contrary, gave priority to economic over state restructuring. Major reforms including mass privatization were implemented in an environment of a weak state, which did not have the capacity to protect its ownership rights and coordinate reforms. As a result, privatization was a wasteful process associated with asset stripping and consequently with lack of legitimacy of newly established property rights.[3]

The Chinese government has emphasised market-led growth by raising personal incomes and consumption while helping newly privatised industries to increase productivity through technology transfer and improved management. These aims, together with a policy of export-led growth, have been supported by the influx of FDI, also driven by the liberalisation process. Multinational investors have pushed up exports while creating alliances and joint ventures which have helped local firms develop the necessary assets and skills to become more productive (although some studies argue that the effect has been to limit the competitiveness of local enterprises as they have become subordinate suppliers to Western MNEs).

China's central and provincial governments have worked on a 'three-step development strategy', since the 1980s. This has involved regional development initiatives, now focused on controlling growth in the east of the country and subsidising growth inland. 'Key national projects' have supported infrastructure development on a massive scale, and the targeting of strategic industries, assets and technological capabilities. Over time these kinds of government-directed initiatives have become increasingly international, as part of the '**Going Global**' strategy. President Xi Jinping, following Wen Jiabao, who followed Zhu Rongji (starting in 2001) have all strengthened this approach as part of continuous government push for the development of national industry champions and the procurement of natural resources abroad. Both underpin a broader agenda of economic nationalism including energy security, geo-political positioning and national competitiveness.

President Xi continued in this vein to drive a specific programme of Chinese global expansion through the **'Belt and Road Initiative' (BRI)**, launched in 2017 (see below, the **Real Case on 'China's One Belt One Road'**). This was first proposed in 2013 as the 'Silk Road Economic Belt' but took shape several years later as the economic imperative to increase

exports and internationalise the Chinese economy became stronger. The central focus was a portfolio of large-scale infrastructure investments including roads, ports and railways across 65 countries to link China through Asia and Europe to international export markets. Billions-worth of funding from the China Investment Bank and the four largest state-owned commercial banks was pumped into six economic corridors through developments managed by Chinese companies and international joint-venture partners. Energy security and the development of political influence across countries receiving investment were also key objectives.

Another major policy objective in China has been to boost high-technology industry sectors. In 2010 PRC President Hu Jintao stated: ‘A nation’s technological competitiveness determines its place and future in international competition.’ Efforts were led by the National Development and Reform Commission as part of the country’s twelfth five-year plan and continue in the current plan. Key industries, including information technology, biotechnology, aerospace, new materials, high-tech services, new energies, and marine science and technology, are the focus of this initiative. The government is also both facilitating local technology-based start-up firms and encouraging high-tech FDI by upgrading the R&D infrastructure to develop innovative, patentable technologies. There has been a huge expansion in the number of researchers in China over the past two decades. China now counts more researchers than Japan, and is on its way to potentially overtake the EU in this regard. The country is already second only to the United States in terms of advanced technology exports, and it overtook Japan to become the second-largest investor in R&D (spending $121 billion in 2010). Since 2010 China has continued to be the second largest investor in R&D, spending $284 billion in 2014 and over $370 billion in 2019. The USA (spending more than 10 times the UK budget on

R&D), together with China account for almost half of the world's R&D spending.

In the coming years, China plans to reduce its external imbalances; boost domestic demand, particularly consumer demand, and rebalance investment and consumption; further promote balanced external sector development; speed up financial reform; and further improve the exchange regime 'in a gradual and controllable manner'. There are, however, a range of ongoing problems, including: large disparities in per capita income between regions; unemployment, particularly affecting previous employees of **state-owned-enterprises (SOEs)** and migrants; corruption and other economic crimes; poor health and safety standards (for employees and consumers); environmental damage and social problems related to the economy's rapid transformation; and a rapidly aging population, due to the one-child policy.

The government retains substantial control over some areas of the economy (such as energy and transportation, financial markets, news media, infrastructure, land and property) and is influential in others (aerospace, telecoms, construction, retailing and creative media) and less involved in others (automotive and consumer products). This means there are different levels and types of control exerted in different spheres of life. Add to this the variety of levels of government, from central to provincial to city and town, and the fact that these are no longer 'harmoniously aligned'. Also add the fact that the application or implementation of laws and regulations varies greatly according to the specific location, situation and people involved, and we begin to get an idea of the reasons why China plays by different rules of the game (see **Active Learning Case: Oxford instruments in China** above).[4]

MNE INVESTMENT INTO CHINA

The massive growth of FDI into China has created the largest array of international mergers and acquisitions, alliances, joint ventures and partnerships ever witnessed. These are clearly a major source of complementary assets, resources and capabilities for the Western multinationals and the local companies involved, which engage in a reciprocal give-and-take as part of the process of market entry.

China holds the double attraction for MNEs of a cost-effective source of production inputs, particularly cheap labour and a growing consumer market. These strategic drivers equate to two simple forms of investment rationale: input-oriented investments and output-oriented investments. The former are designed to gain access to local resources, endowments and country-specific advantages (CSAs) that will help the firm develop, produce or deliver a product or service cheaper or better in some way. The latter are designed to expand sales by tapping into new and/or growing markets. Greater profitability should result from either or both, if they prove successful.

INTERNATIONAL BUSINESS STRATEGY IN ACTION

Airbus secures a deal with China

Headquartered in the Netherlands, but with its main office in France, Airbus SE is a multinational organisation that designs, manufactures and sells products in the commercial aircraft, defence and space, and helicopter sectors. Within the helicopter industry, Airbus is the market leader in terms of revenue. In 2017, the firm employed around 130,000 people across 180 locations worldwide. Moreover, Airbus earned revenues of $75.27 billion and had a net income of $3.2 billion in 2017, which was an impressive 189 per cent increase compared to the previous year. In the same year, it also purchased a majority stake in one of Bombardier's aircraft (C Series).

During Xi Jinping's visit to France in 2019, Airbus secured a whopping $35 billion deal with China's President. The deal was said to include both new and classic engine options for Airbus's A319, A320 and A321 models. Reportedly, the majority of A320s and A321s will consist of new engine options. It is not unusual for China to make big deals in the aerospace industry, having ordered large batches of aircraft in the past and allocating them to airlines over the following couple of years. China and France have a long relationship within the aerospace industry, and Airbus's Chief Executive, Guillaume Faury, went on record to state that the production of the A320s will take place both in China and Europe, and that this deal was 'a sign of confidence' from China.

China are keen to make large orders of aircrafts because the nation is forecasted to become the world's largest aviation market by 2022. Currently, China is the second largest economy in the world and the nation's impressive economic growth over the last two decades has inevitably meant that there has been a boom in the middle class, who prefer to travel by air. Figure 20.2 shows that from 2007 to 2016, the number of air passengers increased from just under 200 million to around 500 million annually. Although domestic flights heavily dominate the airline industry in China, over the last few years international flights have been increasingly popular. The International Air Transport Association predicts that the number of new air passengers will increase by 921 million people by 2036, yielding a total of 1.5 billion air passengers. Therefore, China will account for approximately 20 per cent of the global air market by 2036, becoming the world's most important

aviation market as the rise in middle class income earners continues to drive up demand for air travel. To accommodate China's demand, the nation will need to purchase around 7,400 new aircraft (commercial and freight) over the next 20 years, so it is expected to make more large orders of aircraft over the coming years.

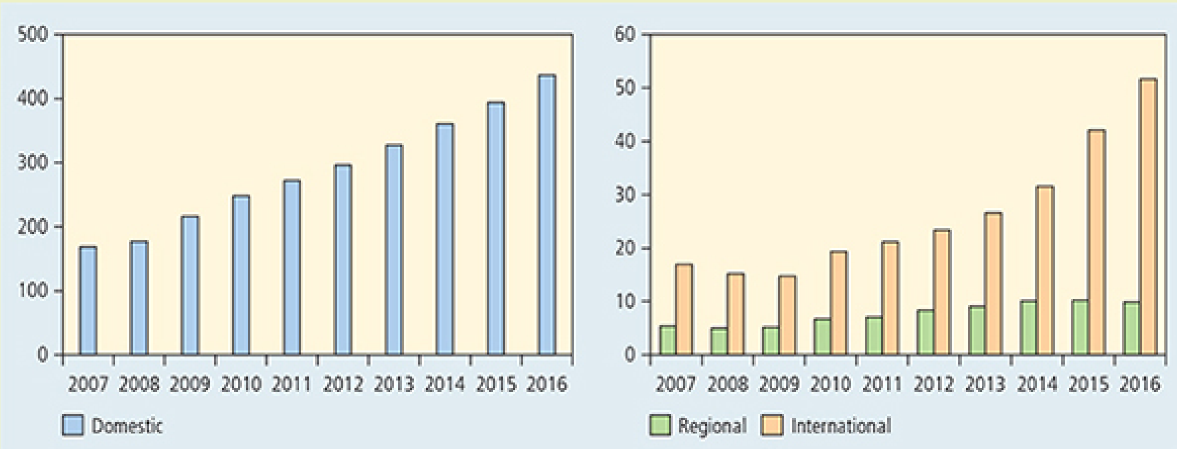

Figure 20.2 China's air passengers, 2007–16 (millions)

https://www.weforum.org/agenda/2018/08/these-five-charts-show-how-rapidly-china-s-aviation-industry-is-expanding/.

In the past, China looked to maintain a balance when purchasing its aircraft from the two largest aircraft manufacturers, Boeing and Airbus. However, following the US–China trade-war, China's orders from American-based Boeing inevitably declined. Its shift to buying more Airbus products was also driven by the 2018 Lion Air disaster in Indonesia, and the Ethiopian Airlines crash at the start of 2019, when Boeing grounded all of its bestselling 737 Max jets. In June 2019, the United States Federal Aviation Administration found that the 737 Max and prior 737 generations may have contained parts that were improperly manufactured. With this in mind, China quickly went on the record to state that it was looking to exclude all of Boeing's troubled 737 Max's from a list of American exports it would buy as part of a trade deal with the US.

The problems with Boeing could have positive repercussions for Airbus, but it is important to note that in 2019 the European aircraft manufacturer had one of its slowest starts of the past decade. In early 2019, Airbus registered 103 cancellations and only received four new orders for aircraft. Airbus also decided to pull the plug on its struggling A380 superjumbo, which entered

service in 2007. Although Airbus initially received relatively large orders from Emirates (162 A380s), other airlines were slow to purchase A380s, with the second largest order from Singapore Airlines totalling only 24 A380s. Airports around the world were reluctant to invest and undergo the necessary changes (wider taxiways, larger holding rooms and amenities for passengers, bigger hangars) to cater to the sheer size of A380s. While a seating capacity of 800 may seem impressive, the size of the aircraft presents operational complexities for both airports and airlines.

China is forecast to soon become the world's largest aviation market and has begun to domestically manufacture aircraft to align with increasing demand. To some, this is China's attempt to reduce its dependency on Western firms. However, the aircraft manufactured by Commercial Aircraft Corporation of China, also known as Comac, have received criticism rather than praise. Few analysts believe that Chinese aircraft will be able to rival those produced by giants Airbus and Boeing over the next few years. However, China's wider push into high-tech manufacturing could trouble Western firms in the longer term. Comac currently has only has one model, the 90-seat ARJ21 jet, in service; an aircraft that has been plagued by delays, noise and other issues which render it inferior not only to Boeing and Airbus, but also to other competitors including Brazil's Embraer and Canada's Bombardier. For the time being at least, China must rely on securing large deals with reliable suppliers such as Airbus to fuel the growth in its aviation market.

Source: https://www.bloomberg.com/news/articles/2019-03-25/airbus-is-said-to-seal-long-awaited-aircraft-order-from-china; https://www.bbc.co.uk/news/business-47689386; https://www.scmp.com/news/china/diplomacy/article/3003233/blow-boeing-china-buy-hundreds-airbus-jets-mammoth-us35; https://www.bbc.co.uk/news/business-47231504; https://www.bbc.co.uk/news/business-47562727; https://www.bbc.co.uk/news/business-42623081; https://www.army-technology.com/features/worlds-biggest-aerospace-defence-companies-2018/; https://www.weforum.org/agenda/2018/08/these-five-charts-show-how-rapidly-china-s-aviation-industry-is-expanding/.

First and foremost, China has a reputation as a cheap manufacturing hub, so cost advantages are still the primary motivator for many companies. The average factory wage (around $260 per month, but varying by region and type of employment) is far less than in more industrialised Pacific Rim countries such as Taiwan and much lower than anywhere in the triad regions. In addition to low labour costs, other positives of sourcing in China include: lower capital costs and low-cost product design and R&D; large manufacturing capacities; and, for some, improvements in quality. The negatives include: communication problems, low product quality, long initial start-up times, intellectual property theft, increased management complexity, and operational and supply-chain challenges. Because the positives outweigh the negatives, China attracts very large amounts of inward FDI. This reached record levels in 2018 with US$142 billion worth of FDI, up 3 per cent from 2017 levels and second only to the USA.

At the same time, the rapid growth of the economy and the country's growing purchasing power are increasing consumer purchasing power as well as channelling investment into transportation, energy, utilities, communication systems and other parts of its infrastructure. In response to these attractions, MNEs have made a large number of investments in China and the country now hosts the largest number of MNE affiliates of any economy, employing an estimated 26 million people.

Most investments have been in the form of equity joint ventures or WFOEs. However, because of the evolving legislation governing foreign investment into China, there has been a noticeable shift in the mode of market entry by foreign firms towards M&As and WFOEs. Ten Asian locations (Hong Kong, Macau, Taiwan province, Japan, the Philippines, Thailand, Malaysia, Singapore, Indonesia and South Korea) account for over half of FDI inflows. This shows a strong regional effect, with Japan, China and the larger satellite Asian economies evolving a strong, mutually

beneficial growth cycle of trade and FDI. The United States, Japan and the EU account for roughly similar proportions of FDI in China.

60–70 per cent of FDI each year is in manufacturing industries and cumulative FDI in China's high-tech industry is over $150 billion, with more than 800 foreign-affiliated high-tech companies operating R&D facilities in China. But service-related FDI is also growing. Investment in China's burgeoning retail industry, for example, is very healthy. One estimate suggests that 70 per cent of the world's largest 50 retail firms have invested in China. Walmart (United States), was ranked the largest in 2019, with 432 stores having initially expanded its presence in China through the acquisition of Trust-Mart. Carrefour (France) was one of the first-movers and is believed to be number two after Walmart. Finally, Tesco (UK) was a relative latecomer, completing a merger in 2014 with Hong Kong-listed retailer China Resources Enterprises (CRE) to boost its presence.

But the major distinguishing feature of China's inward FDI is the wide range of firms and industries involved. The top MNEs from all industries have a presence, including Occidental Petroleum (coal mining), Motorola (producing semiconductors and mobile phones), General Motors and VW (joint ventures with a Shanghai automotive company), Dow Chemical (a polyurethane production joint venture), Heinz (a baby-food plant), Procter & Gamble (a joint venture producing laundry and personal care products), Hewlett-Packard (electronics joint ventures), RJR Nabisco (manufacturing Ritz crackers, among other food products), Airbus and Boeing (a series of joint ventures), Rolls-Royce (aero engines), Seagram (whisky and wine), Babcock & Wilcox (a joint venture making boilers) and Mitsubishi (a venture to build elevators).

Volkswagen, the largest German auto firm and one of the first foreign car manufacturers to enter China is committed to over $15 billion further investments in the areas of electric vehicles, digitalisation and new mobility

services. Other firms on this growing list include Bell Telephone, DaimlerChrysler, General Bearing, Gillette, Lockheed, Pabst Brewing, Peugeot, Squibb, VW and Xerox. P&G even spent $300 million in one year just marketing one product: Oil of Olay!

A regional investment pattern is also increasingly strong. For example, Taiwanese firm Hongfujin Precision Industry (Shenzhen), a subsidiary of Hon Hai Precision Industry (also known as the Foxconn Group), employed almost 1 million Chinese, mainly in the coastal region of Shenzhen. But it has progressively moved its manufacturing operations into cheaper regions away from the east coast, including Chengdu and Wuhan. The firm makes products for top global brands like Apple and Dell and has been involved in several controversies in the past, relating to how it manages employees in China. Fires, accidents and staff injuries, plus a well-publicised series of suicides affected iPad production lines and threatened to damage Apple and other global brands. It has since improved its health and safety record and despite these unfavourable news headlines, China still attracts electronics manufacturing companies. Samsung has been increasing its investments into the production of memory chips in Xi’an. M&A and joint-venture activity has also been strong in this sector, such as Apple and Japan’s Soft Bank’s investments into Didi Chuxing. An increasing number of MNEs have also established regional headquarters in Chinese cities such as Beijing and Shanghai. IBM relocated its global procurement headquarters to Shenzhen some time ago and is unlikely to move this inland.

Other firms investing in China lose money, but believe that they have invested in ‘a foot in the door’ to the most important growing region in the world. Others have failed to break into the market at all. Some have followed something of a ‘herd mentality’ to get into China have failed to do their homework and been surprised to find how different, difficult and risky the country is for inward investors (see the next section). Among those firms

which failed miserably in China was New Zealand's Fonterra. Fonterra used to own 43 per cent in the joint venture with Sanlu Group. Sanlu was a state-owned Chinese dairy products company based in Shijiazhuang, the capital city of Hebei Province. It was one of the oldest and most popular brands of infant formula in China before it went bankrupt. In September 2008, Sanlu was involved in an adulterated milk powder scandal, affecting some 294,000 Chinese infants and killing six. Their baby milk powder had been tainted with melamine, which can cause kidney stones and other complications. It received a bankruptcy order from Shijiazhuang Court on 24 December 2008 and several of its top managers were sentenced to long prison terms. As a direct consequence of the criminal contamination of milk in China, Fonterra recognised an impairment charge of $139 million against the carrying value of its investment in Sanlu. Following this impairment charge, Fonterra's best estimate of the book value of its investment in Sanlu was approximately $62 million, which was 69 per cent below its previous carrying value. In the process, Fonterra learnt a painful lesson in international business.

Foreign R&D investment

China's investment in R&D grew 10-fold from 2000 to 2017 while US investment grew 39 per cent. In that period, China overtook all other OECD countries to become number two in the world after the USA. It also overtook Japan in 2018 to become the second-largest patent filer in the world.[5] But a large proportion (some estimates suggest up to 35 per cent) of R&D investment is by foreign firms based in China.

MNEs, particularly those in IT hardware, the automotive industry, and pharmaceuticals and biotechnology, invest massively in R&D. Some of the largest investors, such as Ford Motor, Pfizer, DaimlerChrysler, Siemens, Toyota Motor and GM, spend more on R&D than the vast majority of developing countries. Only China, Taiwan, South Korea and Brazil come

close to these individual firms in terms of total, national-level R&D expenditure. So, the recent shift of R&D investment from the triad to emerging market economies and especially to China is significant. China is the most favoured destination for MNEs looking to invest in R&D abroad.

By 2019 there were over 1,500 foreign R&D centres in the country, up from 200 in 2014. In many cases inward investors are competing for privileged access to the Chinese market and will offer high-technology investments to gain government support for projects. GM's automotive R&D centre, for example, was established in the late 1990s when global car companies were fighting to get the best joint ventures with a few, government-supported local firms. Boeing (United States) and Airbus (a European consortium) were also under pressure to transfer technologies and established local training in return for access.

Electronics and ICT (information and communication technology) firms were among the earliest entrants. Motorola established the first China-based R&D centre of any MNE in 1990 and now has a large number of centres there. Microsoft also has numerous centres with Microsoft Research Asia (MRA), one of the largest R&D centres in the world, responsible for the firm's basic R&D for the Asian region. Nokia also has five centres in China, making its initial investment in 1998. General Electric located one of only three of its global R&D centres in Shanghai in 2003. But local firms also play a leading role. One estimate suggests that Huawei alone accounts for 7 per cent of all Chinese corporate R&D investment. The China National Petroleum Corporation is among the largest mainland investors and Alibaba is also in the top group of spenders.

Pharmaceutical firms have followed suit, including $100 million research centres for both Novartis and GSK in the late 2000s. The former, based in Shanghai, focuses on the infectious causes of specific types of cancer endemic in China and Asia. It also works to combine Western technology

and drug-discovery approaches with the traditional methods of Chinese medicine.[6] For pharmaceutical firms the relatively low costs of field trials in China is one reason to invest.

More generally, the shortage of science, technology and engineering expertise in the West is a major driver. While the EU is said to have a shortfall of around 700,000 science and engineering personnel, China hosts almost a million (second only to the United States), who are also cheaper to employ. Alongside this input-oriented or resource-oriented rationale for FDI in R&D, there are output-oriented or market-oriented reasons for R&D investments. These include the fact that industrial partners have moved to China. So, for example, much of the R&D conducted by Motorola's semiconductor and component divisions requires close collaboration with customers. Existing, Western-based customers have moved manufacturing activities to China and new customers are also emerging in China and the Asian region. These trends combine to create a strong incentive for Motorola to move its R&D 'centre of gravity' away from the West. China is also becoming a lead market for some technologies. Again, taking the Motorola example, advanced consumer use of mobile phone services in China makes it a lead market for user-led innovation, prompting firms to locate R&D activities there to keep up with adoption trends.

Over the longer term we can expect benefits for research institutes, universities and local firms as MNE R&D networks supplement and support China's national system of innovation. The Chinese government has identified foreign R&D investments as a critical part of China's technology development strategy, originally outlined in the tenth five-year plan (2001–05), now a core part of subsequent five-year plans. This connects to its drive to educate millions of science, technology and engineering graduates, many on funded courses abroad, to bring back the latest ideas to China. Over 100 industrial parks dedicated to Chinese graduates returning from overseas to

set up businesses have also been established. Well-educated graduates and a very good science and technology infrastructure, relative to other developing and emerging countries, are important national assets for China. These are now underpinning the growth of high-tech local firms.

✔ Active learning check

Review your answer to Active Learning Case question 1 and make any changes you like. Then compare your answer to the one below.

1 **Why has OI invested in China? In what ways does its strategy fit with current trends in China?**

OI's investment in China was mainly 'market seeking', in that the firm had experienced growing sales through exports to China in the past and expected to further increase sales by establishing a presence in the market, alongside its customers. This investment has paid off well, with both exports and locally manufactured product sales growing well. FDI to establish local customer services and representative sales offices has supported this success. OI is benefiting from cheaper local assembly costs for some products and has recently developed some R&D partnerships. These count as 'resource-seeking' investments. Its strategy has continued to fit well with current trends in China. The growth in local demand for its products comes from both Chinese firms and foreign MNEs, including OI's customers in the United States and Europe that have moved operations to China. China may also evolve into an important source of inputs for its worldwide product development and R&D efforts in the future.

GETTING INTO CHINA

According to folklore in China, 'the mightiest dragon cannot crush the local snake'[7] – in other words, local advantage can help a great deal in fending off larger and wealthier 'predators'. In response to the very different market conditions and complex local rules of the game in China, it is more common for multinationals to use intermediaries in the process of establishing a local presence here than elsewhere in the Pacific Rim. Government agencies such as those connected to the Ministry of Foreign Trade and Economic Cooperation offer such assistance, as do banks, law firms, and a vast range of consultancies.

As discussed above, the Chinese economy is centrally planned to some degree and the rights of all firms and individuals are strongly influenced by central, regional, and local government agencies. The government has a priority list of desired investments: ventures involving advanced technology, exports, or the generation of foreign exchange are given the highest priority. Understanding the policy agenda and the people responsible for formulating, revising and implementing it is critical for market-entry strategies and continued survival in China. Local policy is also connected to high-level political forces that are important to understand. For example, at the international level, China has been running a large trade surplus with the United States in recent years, and there is every reason to believe that, unless this situation is corrected, the US government will limit Chinese imports. The European Union has also been talking about limiting clothing imports from China because of the threat to local manufacturers (effectively because they are 'too competitive'). These political reactions could result in a backlash against triad MNEs in China. These and other sources of country

risk that can affect the success of an overseas investment should also be taken into account when considering the mode of entry adopted by MNEs.

But things have certainly improved for foreign firms looking to enter the market. China was ranked 46th out of 190 countries in the World Bank's 2019 Doing Business report, which measures the costs, timescales and hassle factor of starting up businesses in countries around the world. The year before China was ranked 78th out of 190 and it has been much further down this list in the past.[8]

In terms of mode of entry, firms can invest via a range of FDI mechanisms, including Sino–foreign joint ventures, joint exploitation and exclusively foreign-owned enterprises (or WFOEs), foreign-funded shareholding companies and joint development companies:

1 Sino–foreign joint ventures, also known as joint shareholding corporations, generally require the capital from the foreign party to be at least equal to a 25 per cent share in the enterprise, according to Chinese regulations.

2 Cooperative businesses, also called contractual cooperation businesses, have the rights and obligations of different parties embedded in the contract. The foreign partner generally supplies all or most of the capital while the Chinese party supplies land, factory buildings and other facilities.

3 Exclusively foreign-owned enterprises take the form of limited liability companies, and regulations formally call for these to 'adopt international advanced technology and facilities' or 'all or most of the products must be export-oriented'.

4 Joint exploitation, development and production enterprises relate to maritime and overland oil exploitation.

5 Foreign-funded shareholding companies involve Chinese and foreign shareholders holding the shares of the company and accepting liability according to proportional ownership. The shares held by foreign investors must account for more than 25 per cent of the total registered capital.

Lessons from foreign firms that established operations in China some time ago and have developed some experience adapting to the local business environment illustrate some of the key difficulties. A survey by the US Embassy in Beijing and Gallup received 286 responses from American investors in China.[9] About half said they were profitable and a further half of the remaining firms were investing more in anticipation of future profits. They reported a number of difficulties that created additional risks or costs, or required adaptation. The biggest problems were said to be, in order of importance:

- transparency of laws and regulations;
- cost of doing business;
- customs procedures/export procedures; and
- foreign exchange regulations/exchange rate risk.

Drawing on a number of surveys, some key issues for foreign entrants are as follows:

- Market-access rights from equity holdings to taxation levels vary by industry and are changing rapidly. At least three, often more, levels of government, including local, regional and central government agencies, have a direct and strong influence over the local rules of the game and give preferential treatment to local firms and to particular kinds of foreign investors.

- Chinese tax laws and other regulations governing business practices are complex. Despite the expense, it is necessary to use attorneys, accountants and consultants familiar with Chinese requirements.
- Contracting tends to be based around relationships and connections (**guanxi**) rather than formal, legal documents. These are the basis of mutual trust, with due diligence on potential business partners performed by checking their network connections, as opposed to formal market mechanisms. Relationships with the right connections are critical. Developing guanxi connections with the wrong partners creates obligations that may act as a trap. Contracts are just a starting point for doing business, not the end goal.
- Intellectual property rights (IPR) are not well protected, legally or via any local business ethics. Investors need to carefully consider the implications of this, including the possibility of local firms getting and using key assets such as brands, patents and business systems.
- Keeping face and being respectful are important. Group orientation and steeper hierarchies characterise Chinese organisations.[10]
- Learning the language may be important in order to provide insights into the local business culture. But too much of a willingness to do things the local way can be seen as a sign of compromise and ultimately weakness. Respect and credibility often come from asserting one's own practices and rules of the game.
- The role of the Chinese partner in the success or failure of a joint venture or alliance cannot be overemphasised. Good partners will have the connections to overcome obstructive red tape and enable success; bad partners may have no power or knowledge to deal with obstructive bureaucrats, may violate confidentialities and/or may establish competing businesses.

- Although there is a large, cheap general labour pool, skilled managers, particularly those with marketing expertise, are difficult to find and keep. Engineers and technicians are similarly difficult to hold on to.[11]

In some business sectors, joint ventures are required, or were required until recently, by the Chinese government. In a joint venture the local partner is typically responsible for providing the land and buildings and for carrying out local marketing. The MNE is expected to contribute the equipment, technology and capital and to be responsible for export marketing. In those cases where the multinational is manufacturing for sales in China, high-quality products, excellent service and good promotional efforts are critical to success. Researchers have found that outstanding service and effective promotion can often make up for some lack of quality. However, price reductions and special sales terms are unlikely to offset poor quality. Similarly, while customer relations are important, they are often not enough to make up for poor quality or poor service. The Chinese want to buy the best quality available.

Table 20.4 Common examples of synergies between foreign multinationals and local Chinese firms

Type of partnership	Foreign multinational firm provides . . .	Local Chinese firm provides . . .
Manufacturing joint venture or subsidiary–local supplier alliance	• **Finance** • **Technology, production systems, management systems (control, coordination best practices, performance measurement, IT, etc.)** • **Management expertise, engineering, and plant-level training**	• **Land, labour, facilities, finance** • **Links to/knowledge of suppliers, buyers, contractors, distributors** • **Access to local resources, materials** • **HRM expertise, recruitment capabilities**

		• **Local government connections, knowledge of local regulations**
Product development joint venture	• **Finance** • **Technology and product development tools, processes, best practices, and expertise** • **Links to other sources of expertise inside and outside the firm**	• **Facilities** • **Finance** • **Some engineering, technical expertise** • **Knowledge of regulations, IPR protection strategies, and relevant connections** • **Links to/knowledge of customer preferences and distribution channels**

In light of these challenges, joint ventures have a number of both benefits and problems. Majority-owned joint ventures give foreign firms an element of control combined with the benefits of gaining immediate access to experienced managers and their local relationship networks. Experienced managers report on the benefits of being able to access local business knowledge, including customer and supplier connections and getting assistance with local officials and regulations. Local firms and/or experienced local experts are normally important for helping customise and adapt existing products and services for local markets, and for developing new ones targeted at the Chinese market. Table 20.4 outlines some of these synergies between foreign and local firms.

✔ Active learning check

Review your answer to Active Learning Case question 2 and make any changes you like. Then compare your answer to the one below.

2 Which 'mode of entry' did OI select in China and what kinds of operational and practical challenges did it face?

OI registered as a wholly foreign-owned enterprise (WFOE) and established a manufacturing facility through this route rather than via a joint venture. Its major challenges, like many foreign firms in China, included the need to: understand and comply with local regulatory and legal conditions and deal with Chinese central and local authority bureaucracies; develop relationships with local customers and adapt to their contracting behaviours; recruit and train (and retain) local experts; develop an effective working relationship between the local offices and the UK-based divisions; and protect its intellectual property rights.

Studies show that recruiting, managing and motivating personnel rank very high among key difficulties faced by foreign managers, even when working with local partners. Skill shortages and weaknesses in Chinese management, and the resulting low levels of labour productivity, also presented significant problems. But this can also reflect a failure on the part of foreign managers to (1) differentiate between labour costs and productivity in preparation for investing in China and (2) sufficiently adapt management and working practices to get the best out of a Chinese workforce. Regarding the first point above, this is a common theme in international business, stemming from the tendency for firms to focus due-diligence efforts on cost cutting and 'sell' investment propositions internally and externally on the basis of simple financial metrics. Comparative data on labour costs per hour are relatively easy to gather. Productivity and other

business performance measures are context specific and influenced by multiple factors and much more difficult to anticipate. They are therefore often overlooked, misunderstood and under-estimated when firms plan international investments.

According to experienced expatriates, one of the most remarkable aspects of China is the sheer drive and motivation of its people. In general, they are very hard working and ambitious. Local cultural values and China's past history have a strong influence on workplace behaviour, underlying a reluctance to take the initiative and the need for detailed instructions, for example. But a massive appetite for learning, advancement and the rewards of capitalism among the people are central to China's growth drive. Cheap labour is one of China's major attractions, but experienced labour is increasingly scarce and there is a talent war for particular kinds of employees. As a result, labour rates are increasing and firms are putting in place a range of strategies to retain good employees. Rises in wage costs may well outpace improvements in the productivity of the country's workforce, which could result in lower export competitiveness.[12]

OUTWARD INVESTMENT AND THE NEW MULTINATIONALS FROM CHINA

As mentioned above (see Table 20.3), outflows of FDI from China have grown rapidly over the last decade, albeit from small beginnings. For some observers, growing outward FDI is a sign of the impending competition from emerging Chinese MNEs set to dominate particular global industries in the near future. For others, this 'infant stage' of international expansion is set to continue for some time with Chinese firms still ill-equipped to significantly expand overseas operations.

Private Chinese companies are stepping up their outward investment, but large SOEs account for the bulk of FDI outflows from China. As a result, much outward FDI (over 70 per cent in past years) has come from large Chinese companies under the state-owned Assets Supervision and Administration Commission of the State Council. As described above, the government is also pushing for further internationalisation under its current 'Belt and Road Initiative').

Total amounts are still, however, a small proportion of global FDI and dwarfed by the stock of inward FDI in China. China continues to face accusations that its outward FDI tends to come from 'state-controlled enterprises with government sanctioned monopoly status' and is biased towards tax havens and neighbouring economies and there is some evidence from a past studies that support this view.[13] The existing capital markets and corporate ownership structures tend to promote international expansion among larger firms championed by the government, particularly in the areas of energy and raw materials (which China is short of), rather than firms that may have particular strategic advantages. There is also criticism that some

firms are using their international operations to support state-backed surveillance, foreign policy objectives or political intervention. Huawei in particular has faced huge barriers to its international sales operations in the US and Europe because of its alleged role as an instrument of the Chinese state (see the **Real Case, 'Huawei accused of spying'** in Chapter 14).

Chinese firms are certainly appearing increasingly prominently in lists of corporate rankings. Table 20.5 shows the top 25 Chinese firms in the *Forbes* ranking of the global top 500 corporations. But the list and many other rankings which show a growing presence of Chinese firms simply measure size and/or profitability, not the degree of internationalisation. Larger Chinese firms are arguably the result of the growing domestic market, not international expansion. When we examine the distribution of assets and sales of these large Chinese firms, we see that they do remain highly dependent on their domestic and regional markets.

Studies that examine the degree to which Chinese firms have internationalised suggest that they are still heavily reliant on country-specific advantages (CSAs) and have yet to develop the requisite firm-specific advantages (FSAs) to break into overseas markets to any great extent. More significantly, the rationale for focusing on domestic and regional (Asian) market opportunities appears to be a significant influence shaping outward FDI.

When they do venture abroad, Chinese firms follow the same logic as other MNEs. They are driven by the two main targets: input-oriented investment (for resources) and output-oriented investment (for market access). As regards the former, a notable increase in Chinese investments in Africa has been driven by the growing demand for energy resources and raw materials in China. A significant proportion of the global growth in oil demand has come from China, hence large-scale investments in Nigeria and other African countries with oil reserves. In the late-2000s large deals in

countries like the Democratic Republic of Congo provided badly needed infrastructure in return for access to raw materials. It involved the building of around 2,400 miles (4,000 km) of road, 2,000 miles (3,000 km) of railroad, plus 32 hospitals, 145 health centres and two universities. China will get access to an estimated 10 million tons of copper and 400,000 tons of cobalt in return.

Table 20.5 Top 25 Chinese (mainland) firms in the 'Fortune Global 5007' list, 2018 ranking

Rank	Global Rank	Company	Revenue
1	2	State Grid	$348,903
2	3	Sinopec Group	$326,953
3	4	China National Petroleum	$326,008
4	23	China State Construction Engineering	$156,071
5	26	Industrial & Commercial Bank of China	$153,021
6	29	Ping An Insurance	$144,197
7	31	China Construction Bank	$138,594
8	36	SAIC Motor	$128,819
9	40	Agricultural Bank of China	$122,366
10	42	China Life Insurance	$120,224
11	46	Bank of China	$115,423
12	53	China Mobile Communications	$110,159
13	56	China Railway Engineering Group	$102,767
14	58	China Railway Construction	$100,855
15	65	Dongfeng Motor	$93,294
16	72	Huawei Investment & Holding	$89,311
17	86	China Resources	$82,184
18	87	China National Offshore Oil	$81,482
19	91	China Communications Construction	$79,417
20	96	Pacific Construction Group	$77,205
21	98	Sinochem Group	$76,765
22	101	China Energy Investment	$75,522
23	109	China Minmetals	$72,997
24	110	China Southern Power Grid	$72,787
25	111	Amer International Group	$72,766

Source: http://fortune.com/global500/list/.

When we examine output-oriented or market-facing investment, it is interesting to note the changes in the kinds of exports and FDI coming out of China, as indicators of its changing competitive advantage. In 1992 around 3

per cent of Chinese exports were categorised as high technology, whereas almost 50 per cent of exports were based on primary products or manufactured products based on natural resources. By 2015 over 30 per cent of exports were high technology and less than 10 per cent were from the latter category above. The initial boost in higher-value exports came from MNEs using China as an export base for their products. But high-technology, high-value products are increasingly exported by local Chinese firms that are moving up the learning curve. This partly explains why this percentage fell from 30 per cent to 24 per cent by 2017.

Local Chinese firms and other firms based outside the triad are able to learn via subcontracting relationships and joint ventures with larger multinational firms. In this sense MNEs are, to a certain extent, 'breeding' their future competitors through the technology and capability transfer that takes place within these interfirm relationships. This may be an unintended consequence of an alliance, or it may be made explicit, through: the transfer of equipment, know-how and training; the licensing of patents or brands; and other activities that are part of the negotiated contract. Western MNEs often trade their own knowledge, technology, assets, resources and networks in order to get access to local knowledge, technology, assets, resources and networks as part of a market-entry or expansion strategy.[14]

Chinese businesses have invested a growing volume of FDI in acquisitions, trade deals and loan agreements abroad. These have had the dual aims of accessing large (though mature) consumer markets and buying assets, technology and expertise to complement their home-based cheap labour and other CSA endowments. Overall, this means that China is evolving beyond its dominance as a global exporter of textiles, clothing and toys, and into areas such as electronics and white goods, consumer electronics and mobile phones. In telecoms, for example, Chinese firms Huawei Technologies, Zhongxing Telecom and Datang Telecom are but

three government-backed, high-tech competitors which are quickly gaining ground against foreign equipment manufacturers, including Ericsson, Lucent, Nortel and Cisco Systems. Huawei commands the greatest market share in China for optical systems equipment, outselling all foreign competitors (see the **Real Case, 'Huawei accused of spying'** in Chapter 14). Motorola and Nokia have pretty much lost their battle for China's mobile handset manufactures to domestic enterprises such as Bird, TCL and Konka. In the semiconductor sector, US government analysts judge China now to be only two years or less behind US manufacturing technology and only one generation behind the commercial state of the art. Huge Dragon and China's largest manufacturer of high-definition televisions Konka are other examples of up-and-coming local firms. Similarly, in computer software, local firms Founder, Red Flag, UFSoft, Neusoft, Kingdee and Top Group are both partnering and competing with Microsoft, Oracle, IBM and Sun Microsystems in niche areas.[15] (See also **International Business Strategy in Action: Alibaba steps up to global competition** below.)

Lenovo, a high-profile Chinese firm, made the news in the early days of foreign M&As when it bought IBM's PC business for $1.75 billion. This was a landmark deal for China, not least because of IBM's status as the archetypal US computer firm. Lenovo, originally called Legend when it was spun off from the Chinese Academy of Sciences in the mid-1980s, makes a large proportion of China-manufactured PCs and laser printers. The sale gave IBM $650 million in cash, along with an 18.9 per cent stake in Lenovo worth $600 million. The merged firm had sales of about $12 billion a year, as well as a five-year licence for IBM's PC brands. Lenovo's PC operations were then moved to be headquartered in upstate New York, rather than Beijing, and the company opened an R&D centre in California's Silicon Valley, as a 'listening post'. Lenovo broke into the mobile handset business in 2012 and was the dominant brand by 2014. Lenovo is also the largest

computer producer in the world and is listed among China's leading 'power brands', many of which are in the white goods and consumer electronics sectors, such as Galanz, Changhong, SVA, TCL and Haier.

As Chinese firms aim to move higher up the value chain, design and R&D activities will become increasingly important, as well as access to advanced market economies abroad. For some fledgling MNEs this means investing overseas to acquire technologies, build or buy distribution networks and brands, and develop a wider portfolio of expertise. For some observers the growth of a new breed of multinationals from emerging economies warrants a new theoretical approach or set of explanatory frameworks. This is necessary, say some, because the current frameworks have developed out of the experience of Western-based MNEs and their international operations in other mature economies of the triad, and expansion into emerging and developing economies. Although the two main types of FDI, input-oriented (resource-seeking) and output-oriented (market-seeking) FDI, are still relevant, the motivations of MNEs from emerging economies are significantly different. Studies indicate that they are internationalising to compensate for current competitive disadvantages, such as technological capabilities and brands, rather than exploiting existing advantages to expand abroad. (The case of Nanjing Auto's takeover of MG supports this view: see the **Real Case: Nanjing Auto makes the MG**.)[16]

INTERNATIONAL BUSINESS STRATEGY IN ACTION

Alibaba steps up to global competition

The Alibaba Group is a Chinese multinational that operates in e-commerce, retail, internet and technology sectors. In 2019, the conglomerate earned about $55 billion in revenue and employed a workforce of 102,000 people. AliExpress is a subsidiary of the group that specialises in ecommerce, selling goods from Chinese retailers to customers in more than 150 countries around the world. In 2019, the Alibaba group decided to restructure AliExpress's business model. It had a market share of 58.2 per cent in e-commerce sales in China (see Figure 20.3), but the ambition was to develop a complete international service that would allow it to compete with firms like Amazon, the world's largest online retailer.

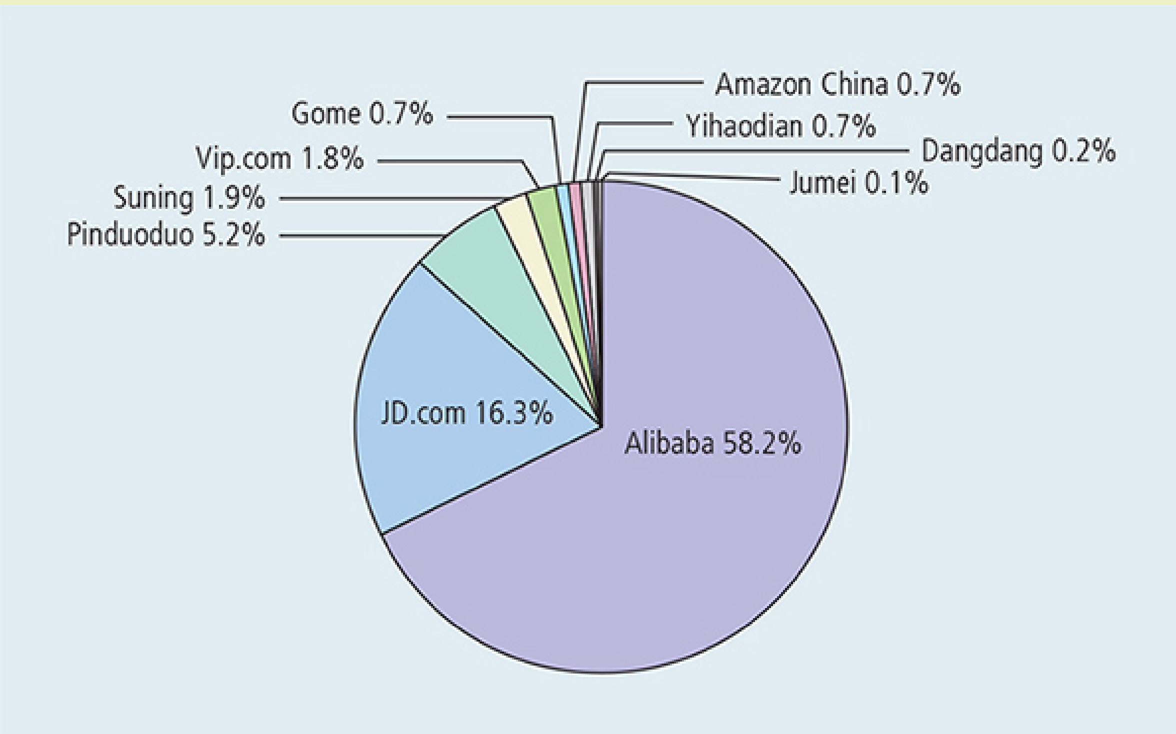

Figure 20.3 **Top 10 e-commerce retailers in China, 2018 (by sales share)**

https://www.statista.com/chart/14717/alibaba-continues-to-lead-retail-e-commerce-sales-in-china-in-2018/.

The president of Alibaba's wholesale marketplaces division, Trudy Dai, went on the record to state that the reorganisation of AliExpress was designed to enable retailers from other countries to also sell products on its platform around the world, creating a global marketplace.

As shown in Figure 20.3, Alibaba's presence in China is unrivalled. AliExpress has a business model whereby it only deals with third-party retailers and the subsidiary has a reputation for selling products at prices which are 'too good to be true'. China's retail market was forecast to over-take that of the US by the end of 2019, making it the largest retail market in the world. American giant Amazon has continually struggled to take a slice of China's retail market, as consumers in China prefer to shop via domestically owned firms such as Alibaba and JD.com. With this in mind, in 2019, Amazon decided to reduce its operational scope in China's e-commerce market. So the two firms have yet to properly go head-to-head for international dominance.

Amazon's penetration rates in the global e-commerce industry remain low, especially in developing nations. In fact, Amazon closed its online store in China, approximately 15 years after its establishment, but Chinese shoppers, can still order goods from Amazon's global store. In a bold move, badged by Alibaba as a 'local to global' strategy, AliExpress opened its platform to vendors overseas. This allowed SMEs in Russia, Turkey, Italy and Spain to register and sell their products to other countries across AliExpress's network. After gaining experience by piloting the approach in these four countries, the Chinese firm intends to expand the offer to firms in other countries. Following its launch in 2019, the firm went on record to state that they had already developed a 'good foundation' of overseas businesses, increasing the portfolio of products available to their consumers. The firm's globalisation strategy also complements the operations of Lazada, another of Alibaba's subsidiaries and the largest e-commerce platform in south-east Asia. The firm has also taken equity stakes in Indonesia's Tokopedia and India's Snapdeal.

Analysts feel that Alibaba's aggressive desire to expand overseas is driven partly by declining growth in the Chinese retail industry. Alibaba is therefore expanding its international scope to offset current or potential future declines in revenues from its domestic market operations. The firm may be at or near the point of saturation in terms of their market presence in their home market, so are looking to expand abroad and accept the risks that this involves. AliExpress, and other subsidiaries like Lazada, are star performers amongst the group's portfolio of businesses. For

instance, AliExpress managed an impressive 94 per cent growth in sales in 2018. Even for a firm like Alibaba this level of success merits investment to expand.

Alibaba's international expansion does not stop there; in 2019, Alibaba also opened two data centres in London – its first ever investment in the UK. This initiative aimed at expanding Alibaba's cloud computing arm in Europe with parallel investments in Frankfurt complementing the UK developments. The London operations will offer 24/7 on-site support, including security and engineering and demonstrate the firm's holistic investment to support its global plans. Currently, Alibaba is ranked fifth and is competing with Amazon, Microsoft, Google and IBM to become the world's biggest cloud computing business. Overall, it seems as though the Chinese giant is making good progress in becoming a potential rival to market leaders like Amazon; however, time will tell if the Chinese newcomer to the global stage can truly compete with the incumbents on their 'home ground'.

Sources: https://www.ft.com/content/3d25007c-713d-11e9-bbfb-5c68069fbd15; https://www.independent.co.uk/news/business/news/alibaba-china-retail-uk-expansion-cloud-data-centre-london-jack-ma-a8595476.html; https://www.engadget.com/2019/05/09/alibaba-opens-ali-express-to-retailers-outside-china/?guccounter=1&guce_referrer=aHR0cHM6Ly93d3cuZ29vZ2xlLmNvbS8&guce_referrer_sig=AQAAAEH0LAlHxs6ZKOqONf4BPIetBcV4Zfig1Y5xR7Ve4JFE_K_b_R3vQLO6K85qWB3ozG_T0scW6yAqOE3_HfW7IegoI0P7dLpiIjTZmsMLF2Eg_zRaXpatAk88g4XVX3FnclNsGv_OxneXvXqQTIcBEH6OHbJ74GCa7fjoV_s18aWn; https://www.bloomberg.com/news/articles/2019-05-09/netflix-signs-deal-with-alibaba-to-add-chinese-language-tv-show.

This view is opposed by others who see existing frameworks as sufficient, perhaps with minor adaptations, to explain and predict the behaviour of Chinese firms. Despite differences in underlying culture, capital markets, economic history and the context from which these firms have emerged, the existing explanations for internationalisation are still perfectly adequate.[17]

Active learning check

Review your answer to Active Learning Case question 3 and make any changes you like. Then compare your answer to the one below.

3 What kinds of threats and opportunities might OI face from new multinational firms from China and what strategic responses should it be considering?

OI is arguably already in a good competitive position in that its profitability stems mainly from its technological capabilities and investments in R&D, rather than low costs. Most large Chinese firms are building from an initial low-cost advantage, so while OI might experience some competition in its low-end businesses, it seems secure for now in the more technologically sophisticated business lines. IPR theft is a continuing threat and may help newcomers catch up rapidly in some key niche areas. But while any high-technology start-ups or established instrumentation firms in China might eventually be able to compete on the basis of new technology developments, they are weak in terms of customer relationships and brand recognition, and therefore have limited access to markets outside China. There may be opportunities for OI to partner with smaller start-ups to develop new products or build relationships with larger customers to provide products, technical services and support as they internationalise.

KEY POINTS

1 One of the most important trends of our time is the economic development of China and its growing importance in terms of trade and FDI, as a cheap manufacturing base, as a growing market and as a source of competitive opportunities and threats for all MNEs. Its economic growth and rising influence in the global economy may, however, be slowed or halted by social and political forces, domestic or international.

2 In terms of the scale, scope and speed of economic growth, China is unprecedented. It is larger and growing faster, across a broader range of industries, than Japan or the Asian ‘tigers’ during their rapid development phases.

3 The Chinese government at various levels has a strong influence over the economy, business practices and the opportunities open to MNEs. The ‘Belt and Road Initiative’ to globalise Chinese industry and the country’s political presence abroad, alongside policies to develop target industries and indigenous innovation capabilities are driven by its powerful central government.

4 Inward and outward FDI have grown. MNEs are attracted to the growing domestic market and opportunities for cheaper manufacturing. MNEs are also establishing R&D activities in China.

5 MNEs looking to get into the Chinese market need to be aware of its particular differences and difficulties, including changing regulations governing foreign investors; customs, tax and foreign exchange procedures; specific cultural traits and the importance of *guanxi*; the

problems with intellectual property rights; and the need to secure good partnerships and local expertise.

6 The current concern is that China and other emerging economies are increasingly competitive in manufacturing, taking investment and jobs from the triad regions. The key concern in the near future will be with their competitiveness in high-technology and knowledge-based businesses.

7 Some Chinese firms are expanding abroad. The extent and impacts of this internationalisation of a 'new breed' of MNEs are hotly debated.

Key terms

- **wholly foreign-owned enterprise (WFOE)**
- **company chop**
- **WTO accession**
- **Going Global**
- **'Belt and Road Initiative' (BRI)**
- **state-owned enterprises (SOEs)**
- **guanxi**

REVIEW AND DISCUSSION QUESTIONS

1. What indicators point to the increasing importance of China and Chinese firms in the global economy? Describe two factors that have helped China's recent economic growth.
2. What makes China an attractive location for inward FDI by MNEs?
3. Give some examples of the national development policies pursued by the Chinese government. Explain how these affect the options open to foreign firms investing in China.
4. What makes China an attractive location for foreign R&D activities?
5. What modes of market entry are open to foreign firms investing in China?
6. What guidelines must MNEs follow when doing business in China? Identify and briefly describe three specific difficulties for foreign firms breaking into the Chinese market.
7. What are the main pros and cons of establishing a joint venture with a local firm for an MNE looking to sell products to the growing consumer market in China?
8. Do you think China will remain a manufacturing hub? How might Chinese firms develop competitive advantages in high-technology and service industries, and what are the implications for triad-based MNEs?
9. What kinds of Chinese firms account for most outward FDI from China?
10. Explain why Chinese firms are investing in Africa.
11. Do you think Chinese MNEs warrant a new theoretical approach to understanding multinational firms and their reasons for internationalising?

REAL CASE

China‘s One Belt One Road

China has become increasingly dominant in international trade over the last 30 years and is revered as the flagship emerging economy. Much of this growth has been based on inward FDI and over the past decade outward FDI has also grown, signalling the country's ambition to expand internationally. In the latest line of expansionist policies, President Xi launched an unprecedented global infrastructure development project, the 'Belt and Road Initiative' (BRI).

The BRI is a $1 trillion project designed to connect Asia with Europe that was unveiled by the Chinese President, Xi Jinping, in 2013. The concept itself is not new; the origins of modern trade can be traced back to the Silk Road, a series of trading routes connecting the East with the West, facilitating the exchange of commodities across borders through merchants who travelled its routes, beginning the process of globalisation that is ongoing to this day. The BRI effectively recreates the ancient route of the Silk Road through its land-based developments (the Road), while also creating a new maritime trading network (the Belt). The aims of the mega-project are fivefold: to increase policy coordination; to provide increased connectivity between facilities; to facilitate trade; to increase financial connectivity; and to forge and strengthen people-to-people bonds. According to Chinese rhetoric, this is a project designed to enhance transcontinental connectivity and in turn reduce the cost of trading, but pessimists have questioned the extent to which this is really an exercise in selfless global development, or a strategic initiative to enhance China's political influence.

The scope of the BRI is vast; its activities involve 65 other countries who collectively account for 30 per cent of the world's GDP and 65 per cent of its population. Within these nations, China is investing to build ports, high speed railroads and oil and gas pipelines among other infrastructure as over 1,700 projects have been associated with the BRI to date. Although the development of routes between Europe and Asia is at its core, the BRI is by no means limited by these geographical boundaries. In 2018, countries within Latin America and the Caribbean were invited to partake in the initiative at the China–Community of Latin American and Caribbean States Ministerial Forum, which resulted in the signing of 16 BRI-related Memoranda of Understanding

by smaller Latin American and Caribbean countries and China, paving the way of business deals between the related parties.

Due to its extensive reach, although China's state-owned enterprises are heavily involved with the projects, they are not exclusively responsible for their delivery; rather, China is urging private Chinese firms to play their part in the development of the 'One Belt One Road' by forging transnational relationships through mergers and acquisitions. In 2017, there were 109 M&As involving China in BRI nations which had a total value of $31 billion; however, the momentum gained by the BRI is evident as this value was surpassed within the first eight months of 2018, demonstrating that ever more valuable deals are being struck to contribute to China's vision. To facilitate BRI projects, China has founded the Asian Infrastructure Development Bank and the Silk Road Fund, but as of the end of 2016, 51 per cent of BRI funding was provided by the big four Chinese state-owned banks with a further 31 per cent coming from China Development Bank.

With such a vast scope and scale, risk is inevitable in a project the size of the BRI. However, analysts have questioned the economic wisdom of some of China's investment decisions, which appear to be driven by political rather than commercial motives. Of the nations involved in the BRI, the Sovereign Debt Funds of 27 are classified as 'junk', denoting very high-risk investments with the strong chance of payment default. Furthermore, another 14 nations have no rating at all. This is a major concern for external observers; as Chinese financial institutions bankroll these huge investments in infrastructure, it is necessary to question the ability of host nations to repay their investors, particularly as China is quick to stress that the BRI is not an exercise in foreign aid. So why are Chinese institutions so willing to engage in such risky deals?

To answer this question, it's interesting to look at the case of the Hambantota Port in Sri Lanka which was built at a cost of $1.3 billion by China Harbor Engineering Company, a state-owned enterprise. From the beginning, this was a commercially questionable venture and was not confined to hard infrastructural development. In fact, the funding for the port was diverted to campaign activities for Mr Rajapaksa, the then-President of Sri Lanka, and in turn, Mr Rajapaksa became an important ally for China by increasing its local influence, to rival that of India within the region. In seeking to build the Hambantota Port, Sri Lanka had turned to other nations for financial support, but due to feasibility concerns India was unwilling to finance the venture; China,

however, did not appear as concerned over the financial viability of the project and pledged its support. Although its origins predate the BRI, it was quickly enveloped into the megaproject's portfolio. Over time, the viability of the port became evident; it was used by a very small number of ships and Sri Lanka was left unable to service its huge debt to China.

In renegotiating the terms of the loan, Sri Lanka agreed to lease the port to China for 99 years in exchange for approximately $1 billion, which would in turn be used to pay its debts. Desperate to avoid defaulting on their loan, Sri Lanka was also forced to hand over 15,000 acres of land surrounding the port for the development of a new industrial zone. The Hambantota Port provides China with a strategic asset in the Indian Ocean and serves as a key point in its new maritime trading route. Aside from that, it is a key point of intelligence for China as it strives to keep abreast of global trade; however, the location has even greater potential for the Chinese.

Nevertheless, Sri Lanka has struggled to manage its sovereign debt, which stood at 77.6 per cent of its GDP in 2017. It remains in debt to China and is grappling with rates that are less favourable than those of other international lenders. Although the initial renegotiation forbids foreign countries from using the Hambantota port and associated land for military purposes unless special permission is granted from the Sri Lankan government, onlookers speculate that such a concession may be made if the host country is forced to once again renegotiate with China to avoid defaulting.

This case, although perhaps the most infamous of the BRI, is not necessarily unique. The credit ratings of the countries hosting BRI projects suggest that the debts being incurred by many hosts are unserviceable, paving the way for Chinese negotiations and future relinquishments of control. As yet, however, the BRI remains in its infancy and the sheer number of projects in development make it difficult to assess the overall risk and impact. All that can be said for certain is that the hard infrastructure developments are reshaping soft infrastructure worldwide and political allegiances globally, and such developments will continue as the project has been enshrined in China's constitution. Although it has been promoted as a venture to develop global integration and harmony, the BRI has been seen by some as a strategic tool for the expansion of Sino-power beyond national borders and a means for China to assert its dominance on the geopolitical stage.

Sources: https://www2.deloitte.com/insights/us/en/economy/asia-pacific/china-belt-and-road-initiative.html#endnote-28%20trump%20and%20trade%20%E2%80%93%20steel%20https; https://www.ft.com/content/e150ef0c-de37-11e7-a8a4-0a1e63a52f9c; https://www.nytimes.com/2018/06/25/world/asia/china-sri-lanka-port.html; https://theconversation.com/the-belt-and-road-initiative-chinas-vision-for-globalisation-beijing-style-77705; https://www.iiss.org/publications/strategic-comments/2018/chinas-bri-in-latin-america; https://www.theguardian.com/cities/ng-interactive/2018/jul/30/what-china-belt-road-initiative-silk-road-explainer.

1 What are the main economic and political aims of China's 'Belt and Road Initiative'?

2 How will this government policy help Chinese firms expand into international markets?

3 What kinds of positive and negative impacts might be experienced by countries receiving inward investment from China as part of the BRI?

REAL CASE

Nanjing Auto makes the MG

China became a net exporter of cars for the first time in 2005, due in part to the large-scale inward investment from non-Chinese car manufacturers, channelled into joint ventures with local firms in this industry. But exports account for a small proportion of total sales. By 2015 annual production in China had reached 21 million and by 2018 this increased to 28 million. Demand from the domestic automotive market has grown fast enough to make China the largest automotive market in the world.

VW entered China well ahead of the competition through a joint venture with the government-owned Shanghai Automotive Industry Corporation (SAIC) in 1984. A second joint venture with the First Automotive Works (FAW) in 1991 helped it reach a dominant position (56 per cent market share) in the growing Chinese car market before other foreign competitors were even allowed to enter. GM was a later entrant and had been involved in a range of technology transfer initiatives before being allowed to establish manufacturing operations in 1997 through a $1.6 billion joint venture with SAIC. GM reached a 10 per cent market share to challenge VW. But both GM and VW faced growing competition from new foreign entrants after the 2001 WTO deregulation rulings began to take effect. Ford, Honda, Toyota, Hyundai, and Suzuki all entered the market in the early to mid-2000s. More significantly, local car makers also started to come into their own around this time.

SAIC, which merged with Nanjing Automotive Corporation (NAC) in 2008, Chery Automobile, and FAW are the largest local producers. SAIC has a string of joint ventures, including with VW and GM, while FAW has partnerships with Mazda and Toyota, in addition to its main ally, VW. In contrast, Chery is one of the more independent local players, as is Geely Automotive Holdings. Initially established as a fridge maker, Geely has steadily accelerated sales and expanded its manufacturing operations to reach a 5 per cent share of the mainland market.

Low cost is the one key advantage at this stage for indigenous car firms, gained through cheap labour, available land and capital (in China much of it initially from the government). This only temporarily makes up for weaknesses in most other areas, from manufacturing technology, process

innovation and product design, to sales and branding. But the industry has moved up the value chain in its short history. Low-cost advantages are increasingly complemented by capabilities in design, engineering, manufacturing, marketing and management, which are driving process and product innovation. Most firms have partly developed and partly bought into these assets and capabilities through joint ventures with Western car-makers. More unusually, NAC accessed them directly by acquiring one of the oldest and best-known car firms in the UK, MG.

Based in Longbridge in the heart of the West Midlands manufacturing region, MG was part of MG-Rover, a corporation that combined two famous British car brands that dated back to the early 1900s. A turbulent history of takeovers and management failures had brought the firm to collapse in the early 2000s, despite the strength of its design, engineering and technology divisions and the loyalty of its customers. In May 2005 NAC bought the MG brand name, physical assets including the powertrain technology, and the manufacturing rights to the MG range of cars in a deal worth over $80 million. In parallel, NAC's then competitor SAIC announced it would build the Rover 75 (relaunched as the Roewe) in China using the rights it had bought from MG-Rover in 2004.

NAC shipped the MG assets to China and, in the space of a year, by March 2007 the firm had set up production in the Pukou High-Tech Development Zone in Nanjing and locally made cars were rolling off the plant line. The aim was to develop the plant to eventually produce 200,000 autos, 250,000 engines and 100,000 gear boxes, with an explicit strategy to keep costs low by expanding and improving the local Chinese supply chain. To do this it has embarked on a wide range of recruitment and training programmes, which involve ex-MG-Rover plant managers, engineers, designers and other employees from the UK operation and from suppliers. These are providing the Chinese with the capabilities not just to operate the plant, but to improve the product design, manufacturing quality and cost, and to conduct R&D and engineering development to create future automotive products.

The acquisition provides an interesting illustration of how far the kinds of advanced assets and capabilities required to produce and sell complex products can be bought and transferred across continents. It begs the question: how far can changes in ownership drive geographic shifts in competitive advantage? What it shows is that knowledge, expertise and skills have to be transferred alongside hardware and technology for the full set of manufacturing process and

product competencies to be developed by the recipient firm. This takes a long time, during which the recipient remains dependent on knowledge and expertise from the firm and/or regional ‘cluster’ of firms in which the original capabilities evolved.

Some of these capabilities will be transferred via training programmes and by recruiting some of the MG-Rover managers, designers and engineers directly to work in China. Others will be accessed by redeveloping some functions at the original Longbridge plant in the UK, linked to the main manufacturing plant in China. Subsequent plans by NAC for Longbridge have included an R&D, engineering and test centre for MG models; HR recruitment and purchasing and logistics centres to serve China and Longbridge; a sales and marketing base for the UK and Europe; and eventually a local assembly plant for European markets. NAC is effectively developing a new multinational network to leverage the location-specific complementarities between the Midlands and Nanjing. It hopes to produce cars for both markets, taking on competitors in both regions. With one acquisition a new MNE is born.

Source: Matthew Lewis/Stringer/Getty Images News/Getty Images

Source: David Lyons/Alamy Stock Photo

Sources: This case was partly developed on the basis of interviews conducted as part of a larger study of MNEs in China. See S. C. Collinson, B. Sullivan-Taylor, and J. L. Wang, 'Adapting to the China challenge: lessons from experienced multinationals', Advanced Institute of Management (AIM) Research, Executive Briefing, London, 2007, http://www.aimresearch.org/publications/adaptingtochina.pdf; http://www.mg-uk.co.uk; Jason Subler and Shen Yan, 'Chinese carmakers merge to take on multinationals', *Guardian*, 27 December 2007; 'The world's big carmakers have unwittingly created a new Chinese rival', *The Economist*, 22 February 2007; Yu Qiao, 'Global, local firms jostle for position', *China Daily*, 21 April 2007. OICA 2015 Production Statistics, http://www.oica.net/category/production-statistics/; https://www.marklines.com/en/statistics/flash_prod/productionfig_china_2018.

1 How have foreign car firms historically established themselves in the Chinese market (what form of FDI?), and why is this mode of market entry normally used?

2 List some examples of firm-specific advantages (FSAs) that are held by foreign car manufacturers and some examples of country-specific advantages (CSAs) in China relevant to this industry.

3 What are the relative costs and benefits of acquiring particular kinds of FSAs, in the way that NAC has done, compared to establishing a joint venture?

NOTES

1 The WTO Agreement on Trade-Related Investment Measures (TRIMs) is still being implemented. It should eventually lead to the end of Chinese requirements on trade and foreign exchange balance, local content and export performance for foreign investors. The Chinese government is also committed to relaxing foreign investment restrictions in many important service industries, including distribution services, telecommunications, financial services and professional services; http://www.wto.org

2 Arie Y. Lewin, Martin Kenney and Johann Peter Murmann (eds.), *China's Innovation Challenge: Overcoming the Middle Income Trap* (Cambridge: Cambridge University Press, 2016).

3 Jeffrey B. Miller and Stoyan Tenev, 'On the role of government in transition: the experiences of China and Russia compared', *Comparative Economic Studies*, vol. 49 (2007), pp. 543–71.

4 A range of texts listed in the Bibliography can provide background on the evolving role of government in China. There are many online sources of information as well, including the official central government website: http://english.gov.cn and other semi-official or at least non-controversial sites, including http://www.chinatoday.com/gov/a.htm and http://www.china.org.cn. There are many other sites that are more critical of the regime in China.

5 https://www.weforum.org/agenda/2018/04/trade-war-or-not-china-is-closing-the-gap-on-u-s-in-technology-ip-race

6 Kerry Capell, 'Novartis in China: East meets West in R&D', *Business Week*, 6 November 2006.

7 This is a quote from Tim Clissold's book, *Mr. China*, taken from 'The Battle of Ningshan' in *Journey to the West*, an unattributed sixteenth-century Ming dynasty novel.

8 http://www.doingbusiness.org/en/reports/global-reports/doing-business-2019

9 The US Commercial Service based in China, part of the US Department of Commerce, provides a Country Commercial Guide. This is continually revised and updated, informed by ongoing studies and surveys. See https://china.usembassy-china.org.cn/

10 Among numerous how-to texts on coping with Chinese culture to 'make it big' in the Chinese market, see, for example, John L. Graham and Mark N. Lam, 'The Chinese negotiation', *Harvard Business Review* (October 2003), pp. 82–91; Tom Orlik, 'China's runaway investment train', *Wall Street Journal*, 26 July 2011; Saira Syed, 'The price of high-speed ambitions', *BBC News*, 28 July 2011.

11 This list partly comes from interviews and discussions, including several with Alice Huang, Managing Director of Enter Consulting, a firm based in Shanghai that supports inward investors. See Collinson, S. C. , Sullivan-Taylor, B. and Wang, J.L. 'Adapting to the China challenge: lessons from experienced multinationals', Advanced Institute of Management (AIM) Research, Executive Briefing.

12 See Lewin et al., *China's Innovation Challenge*; see also 'How rising wages are changing the game in China', *Business Week*, 27 March 2006. This pattern, of rising costs of particular kinds of labor, was predicted by Eli Heckscher (in 1919) and Bertil Ohlin (in 1933) in an economic model that was further refined by the American economist Paul Samuelson. The H-O or HOS model (or theory of factor endowments) took trade theory beyond the simple assumptions made by Ricardo about labour productivity to look at the relative availability

of different factors of production (primarily land, labour and capital) and therefore their relative price (rent, wages and interest) in each country. These will determine the products in which a country has a comparative advantage, and in which it will therefore tend to specialise and trade. See, for example, J. R. Markusen, *Multinational Firms and the Theory of International Trade* (Boston, MA: MIT Press, 2004).

13 Randall Morck, Bernard Yeung and Minyuan Zhao, ‘Perspectives on China’s outward foreign direct investment’, *Journal of International Business Studies,* vol. 39 (2008), pp. 337–50.

14 S. C. Collinson, ‘Who benefits when MNEs partner with local enterprises in China?’, in Lewin et al., *China’s Innovation Challenge*.

15 In fact China’s software industry is comparable in size to India’s but is not export oriented. All the major firms are focused on serving local customers and foreign firms based in China.

16 See Collinson, ‘Who benefits when MNEs partner with local enterprises in China?’, and other chapters in Lewin et al., *China’s Innovation Challenge*. Another study that supports this view is John Child and Suzana B. Rodrigues, ‘The internationalization of Chinese firms: a case for theoretical extension?’, >*Management and Organization Review*, vol. 1, no. 3 (2005), pp. 381–410. Another that takes a slightly different perspective, but still sees emerging economy MNEs as ‘special cases’, is John A. Mathews, ‘Dragon multinationals: new players in 21st century globalization’, >*Asia Pacific Journal of Management*, vol. 23 (March 2006), pp. 5–27.

17 See Rugman, ‘Do we need a new theory to explain emerging market multinationals?’ and Rajneesh Narula, ‘Globalization, new ecologies, new zoologies, and the purported death of the eclectic paradigm’, *Asia Pacific Journal of Management*, vol. 23 (June 2006), pp. 143–51.

BIBLIOGRAPHY

Buckley, Peter, Clegg, Jeremy L., Cross, Adam R., Liu, Xin, Voss, Hinrich and Zheng, Ping. 'The determinants of Chinese outward foreign direct investment', *Journal of International Business Studies*, vol. 38, no. 4 (2007).

Breslin, Shaun. *China and the Global Political Economy* (Basingstoke: Palgrave-Macmillan, 2007).

Breslin, Shaun. 'The political economy of development in China: political agendas and economic realities', *Development*, vol. 50, no. 3 (2007).

Chen, Kun and Kenney, Martin. 'Universities/research institutes and regional innovation systems: the cases of Beijing and Shenzhen', *World Development,* vol. 35, no. 6 (2007), pp. 1056–74.

Child, John. 'China and international business.' In Alan M. Rugman and Thomas L. Brewer (eds.), *The Oxford Handbook of International Business* (Oxford: Oxford University Press, 2009).

Chung, Goo Hyeok, Du, Jing and Choi, Jin Nam. 'How do employees adapt to organizational change driven by cross-border M&As? A case in China', *Journal of World Business*, vol. 49 (2014).

Clissold, Tim. *Mr. China: A memoir* (London: Collins, 2006).

Coase, Ronald and Wang, Ning. *How China Became Capitalist* (Basingstoke: Palgrave Macmillan, 2011).

Collinson, Simon C., 'Cross-border M&A by the new multinationals: different reasons to "go global".' In P. J. Williamson, R. Ramamurti, A. C. C. Fleury, and M. T. L. Fleury (eds.), *The Competitive Advantage of Emerging Market Multinationals* (Cambridge University Press, Cambridge, 2013).

Collinson, Simon C. ‘Who benefits when MNEs partner with local enterprises in China?’ In Arie Y. Lewin, Martin Kenney and Johann Peter Murmann (eds.), *China’s Innovation Challenge: Overcoming the Middle Income Trap* (Cambridge: Cambridge University Press, 2016).

Collinson, Simon C. and Narula, Rajneesh, ‘Asset recombination in international partnerships as a source of improved innovation capabilities in China’, *Multinational Business Review*, vol. 22, no. 4 (2014).

Deng, Ping, ‘Why do Chinese firms tend to acquire strategic assets in international expansion?’ *Journal of World Business*, vol. 44, no. 1, (2009).

Dunning, John. ‘Comment on dragon multinationals: new players in 21st century globalization’, *Asia Pacific Journal of Management*, vol. 23 (June 2006).

Enright, Michael J., Scott, Edith E. and Chang, Ka-mun. *Regional Powerhouse: The Greater Pearl River Delta and the Rise of China* (Singapore: Wiley, 2005).

Fishman, Ted C. *China Inc.: How the Rise of the Next Superpower Challenges America and the World* (New York: Scribner, 2006).

Gaur, Ajai S., Ma, Xufei and Ding, Zhujun. ‘Home country supportiveness/unfavorableness and outward foreign direct investment from China’, *Journal of International Business Studies*, vol. 49, no. 3 (2018).

Hamilton, Stewart and Zhang, Jinxuan. *Doing Business with China: Avoiding the Pitfalls* (Basingstoke: Palgrave Macmillan, 2011).

Hu, Mei-Chih and Matthew, John A. ‘National innovation capacity in East Asia’, *Research Policy*, vol. 34 (2005).

Hu, Helen Wei, Cui, Lin and Aulakh, Preet S. ‘State capitalism and performance persistence of business group-affiliated firms: A

comparative study of China and India', *Journal of International Business Studies*, 50, no. 2 (2019).

Humphery-Jenner, Mark and Suchard, Jo-Ann. 'Foreign venture capitalists and the internationalization of entrepreneurial companies: evidence from China', *Journal of International Business Studies*, vol. 44, no. 6 (2013).

Kafouros, Mario and Wang, Elizabeth Yi. 'Technology transfer within China and the role of location choices', *International Business Review*, vol. 24, no. 3 (2015).

Keeley, James and Wilsdon, James. *China: The Next Science Superpower?* Demos Reports (2007), http://www.demos.co.uk/files/China_Final.pdf

Li, Jian, Strange, Roger, Ning, Lutao and Sutherland, Dylan. 'Outward foreign direct investment and domestic innovation performance: Evidence from China', *International Business Review*, vol. 25, no. 5 (2016).

Li, Jiatao, Liu, Bin and Qian, Gongming. 'The belt and road initiative, cultural friction and ethnicity: Their effects on the export performance of SMEs in China', *Journal of World Business*, vol. 54, no. 4 (2019).

Li, Jing and Li, Yong. 'Flexibility versus commitment: MNEs' ownership strategy in China', *Journal of International Business Studies*, vol. 41, no. 9 (2010).

Li, Kai, Griffin, Dale, Yue, Heng and Zhao, Longkai. 'National culture and capital structure decisions: evidence from foreign joint ventures in China', *Journal of International Business Studies*, vol. 42, no. 4 (2011).

Lin, Hao-Chieh and Hou, Sheng-Tsung. 'Managerial lessons from the East: an interview with Acer's Stan Shih', *Academy of Management Perspectives*, vol. 24, no. 4 (2010).

Ling, Zhijun and Avery, Martha. The Lenovo Affair: The Growth of China's Computer Giant and Its Takeover of IBM-PC (Singapore:

Wiley, 2006).
Liu, Xiaohui, Lu, Jiangyong, Filatotchev, Igor, Buck, Trevor and Wright, Mike. ‘Returnee entrepreneurs, knowledge spillovers and innovation in high-tech firms in emerging economies’, *Journal of International Business Studies*, vol. 41, no. 7 (2010).
Ma, Xufei, Delios, Andrew and Lau, Chung-Ming. ‘Beijing or Shanghai? The strategic location choice of large MNEs’ host-country headquarters in China’, *Journal of International Business Studies*, vol. 44, no. 9 (2013).
Ma, Xufei, Tong, Tony W. and Fitza, Markus. ‘How much does subnational region matter to foreign subsidiary performance? Evidence from Fortune Global 500 Corporations’ investment in China’, *Journal of International Business Studies*, vol. 44, no. 1 (2013).
Mathews, John A. *Dragon Multinational: A New Model for Global Growth* (New York: Oxford University Press, 2002).
McManus, John, Li, Mingzhi and Moitra, Deependra. *China and India: Opportunities and threats for the Global Software Industry* (Oxford: Chandos, 2007).
Meyer, Klaus E. ‘International research in transitional economies.’ In Alan M. Rugman and Thomas L. Brewer (eds.), *The Oxford Handbook of International Business* (Oxford: Oxford University Press, 2009).
Navarro, Peter and Autry, Greg. *Death by China: Confronting the Dragon and a Global Call to Action* (Upper Saddle River, NJ: Prentice Hall, 2011).
Nolan, Peter. Transforming China: Globalization, Transition and Development (London: Anthem, 2004).
OECD. OECD Reviews of Innovation Policy: China Synthesis Report (Paris: OECD, 2007).

Ping Li, Peter. Disruptive Innovation in Chinese and Indian Businesses: The Strategic Implications for Local Entrepreneurs and Global Incumbents (London: Routledge, 2012).

Pollitte, Wesley A., Miller, Joseph C. and Yaprak, Attila. 'Returns to US firms from strategic alliances in China: a knowledge-based view', *Journal of World Business*, vol. 50, no. 1 (2015).

Prestowitz, Clyde. *Three Billion New Capitalists* (New York: Basic Books, 2006).

Quer, Diego, Claver, Enrique and Rienda, Laura. 'Business and management in China: a review of empirical research in leading international journals', *Asia Pacific Journal of Management*, vol. 24 (2007).

Prud'homme, Dan. 'Re-conceptualizing intellectual property regimes in international business research: Foreign-friendliness paradoxes facing MNCs in China', *Journal of World Business* (2019).

Redding, Gordon. 'The smaller economies of Asia and their business systems', in Alan M. Rugman (ed.), *The Oxford Handbook of International Business* (Oxford: Oxford University Press, 2009).

Rugman, Alan M. and Doh, Jonathan. *Multinationals and Development* (New Haven, CT: Yale University Press, 2008).

Rugman, Alan M. and Li, Jing. 'Will China's multinationals succeed globally or regionally?' *European Management Journal*, vol. 25, no. 5 (2007).

Shi, Weilei Stone, Sun, Sunny Li, Pinkham, Brian C. and Peng, Mike W. 'Domestic alliance network to attract foreign partners: Evidence from international joint ventures in China', *Journal of International Business Studies*, vol. 45, no. 3 (2014).

Shi, Weilei Stone, Sun, Sunny Li, Yan, Daying and Zhu, Zhu. 'Institutional fragility and outward foreign direct investment from China', *Journal of*

International Business Studies, vol. 48, no. 4 (2017).
Story, Jonathan. *China Uncovered: What you need to know to do business in China* (London: Financial Times, Pearson, 2010).
Sun, Pei, Mellahi, Kamel and Thun, Eric. 'The dynamic value of MNE political embeddedness: the case of the Chinese automobile industry', *Journal of International Business Studies*, vol. 41, no. 7 (2010).
Taylor, Robert (ed.). *International Business in China: Understanding the Global Economic Crisis* (London: Routledge, 2011).
Tian, Xiaowen and Slocum, John W. 'What determines MNC subsidiary performance? Evidence from China', *Journal of World Business*, vol. 49 (2014).
Tsui-Auch, Lai Si and Möllering, Guido. 'Wary managers: unfavorable environments, perceived vulnerability, and the development of trust in foreign enterprises in China', *Journal of International Business Studies*, vol. 41, no. 6 (2010).
von Zedtwitz, Maximilian, et al. 'Managing Foreign R&D in China', *Research-Technology Management*, vol. 61, no. 3, 29–37 (2018).
Wu, Aiqi and Voss, Hinrich. 'When does absorptive capacity matter for international performance of firms? Evidence from China', *International Business Review*, vol. 24, no. 2 (2015).
Xie, Qunyong. 'Firm age, marketization, and entry mode choices of emerging economy firms: Evidence from listed firms in China', *Journal of World Business*, vol. 52, no. 3 (2017).
Yong Gao, Gerald and Pan, Yigang. 'The pace of MNEs' sequential entries: cumulative entry experience and the dynamic process', *Journal of International Business Studies*, vol. 41, no. 9 (2010).
Zeng, Ming and Williamson, Peter J. *Dragons at Your Door: How Chinese Cost Innovation Is Disrupting Global Competition* (Boston, MA: Harvard Business School Press, 2007).

Zhou, Kevin Zheng and Xu, Dean. ‘How foreign firms curtail local supplier opportunism in China: detailed contracts, centralized control, and relational governance’, *Journal of International Business Studies*, vol. 43, no. 7 (2012).

WWW RESOURCES

http://www.stats.gov.cn/english/index.html
http://english.gov.cn
http://www.chinatoday.com
http://www.china.org.cn
http://www.tdctrade.com/main/china.htm
http://news.bbc.co.uk

GLOSSARY

Acceptance zone. An area within which a party is willing to negotiate.

Achievement oriented. Where status is earned rather than a right; recruitment and promotion opportunities tend to be more dependent on performance, as in a meritocracy.

Adjusted present value (APV). An NPV that takes into account sources of country risk that might impact a project's expected future cash flows.

Ad valorem duty. A tax which is based on a percentage of the value of imported goods.

Advertising. A non-personal form of promotion in which a firm attempts to persuade consumers to a particular point of view.

***Amakudari*.** (Literally 'descent from heaven.') The temporary or permanent movement of public sector officials in Japan into private corporations as a mechanism for coordinating national policy and company strategy.

Ambidexterity. The ability of a firm to be aligned and efficient in its management of today's business demands while simultaneously being adaptive to changes in the environment.

Andean common market (Ancom). A sub-regional free trade compact designed to promote economic and social integration and cooperation; Bolivia, Colombia, Ecuador and Peru are all members.

Andean Community. An economic union consisting of Bolivia, Colombia, Ecuador and Peru.

Anti-dumping duty (AD). Import tariff intended to protect domestic producers from foreign products sold at less than their cost of production or at lower prices than in their home market.

Arbitrageur. A person or firm that deals in foreign exchange, buying or selling foreign currency with simultaneous contracting to exchange back to the original currency; arbitrageurs thus do not undertake exchange risk.

Arm's-length price. The price that exists or would exist on a sale of a given product or service between two unrelated companies—as contrasted with an intracompany transfer price.

Ascription oriented. Where status is more of a right than earned; recruitment and promotion opportunities tend to be more dependent on seniority, ethnicity, gender, religion or birth.

Association of South-East Asian Nations (ASEAN). An economic union founded in 1967 that includes Brunei Darussalam, Cambodia, Indonesia, Lao PDR, Malaysia, Myanmar, the Philippines, Singapore, Thailand and Vietnam; this economic bloc focuses not on reducing trade barriers among members but, rather, on promoting exports to other nations.

Autonomous infrastructure. An infrastructure used by multinationals that compete in dissimilar national markets and do not share resources.

Backward integration. The ownership of equity assets used earlier in the production cycle, such as an auto firm that acquires a steel company.

Balance of payments (BOP). The value of all transactions between a country's residents and the rest of the world; the three broad BOP categories are the current account, capital account, and official reserves.

Balance sheet hedging. The use of financial instruments denominated in foreign currency to eliminate exchange rate (translation) risk from the balance sheet of a company.

'Belt and Road Initiative' (BRI). A programme of Chinese international expansion to increase exports, energy security and political influence through large-scale infrastructure projects (road, rail and ports) connecting China to foreign markets via countries in Asia and Europe.

Benkyokai**.** Study associations or work groups for students or colleagues in companies to jointly develop particular areas of knowledge and expertise.

'Born global' firms. A 'born global' firm is one that is immediately or very quickly reliant on a foreign presence to survive or succeed. Born global firms also engage in early and rapid internationalisation to leverage critical resources beyond their national borders. For example, Logitech, a global leader in computer peripherals, was established with dual headquarters, in the United States and Switzerland, which shared both the R&D and manufacturing activities. It then quickly initiated innovation- and efficiency-seeking FDI to Ireland and Taiwan.

Brexit. The British exit from the EU, voted for by a referendum of the people in 2016, became a complex and drawn-out process

Business managers. Managers responsible for coordinating the efforts of people in a corporate organisation: for example, in a matrix structure.

Canada Labour Code. A federal law that covers areas such as wages, employment practices, work safety, and conciliation of labour disputes.

Capital account. A category of the BOP that consists of transactions that involve financial claims.

Caribbean Basin Initiative. A trade agreement that eliminates tariffs on many imports to the United States from the Caribbean and Central American regions.

Cartel. A group of firms that collectively agree to fix prices or quantities sold in an effort to control price.

Centre-for-global, local-for-local, local-for-global and global-for-global. Structural archetypes for the location of three innovation-related activities: sensing, responding and implementing. These result from the need for some innovation activities to be centralised and/or standardised and others to be de-centralised and/or customised (or 'localised').

Centrally determined economy. An economy in which goods and services are allocated based on a plan formulated by a committee that decides what is to be offered.

***Chu* and *giri*.** *Chu*, meaning loyalty, and *giri*, meaning duty, obligation, or responsibility, are often used together to denote the traditionally close, trusting relationship between managers and employees; they are also used to describe the ties between older and younger members of a family.

Civil society. A group of individuals, organisations and institutions that act outside the government and the market to advance a diverse set of interests.

Clearing account. A centralised cash management bank account in which one MNE affiliate reviews payment needs among various MNE affiliates and arranges to make payments of net funds due from each affiliate to others through the clearing account.

Cluster analysis. A marketing approach to forecasting customer demand that involves grouping data based on market area, customer, or similar variables.

Codetermination. A legal system that requires workers and their managers to discuss major strategic decisions before companies implement the decisions.

Collectivism. The tendency of people to belong to groups who look after each other in exchange for loyalty.

Common market. A form of economic integration characterised by the elimination of trade barriers among member nations, a common external trade policy, and mobility of factors of production among member countries.

Communication. The process of transferring meanings from sender to receiver.

Communism. A political system in which the government owns all property and makes all decisions regarding production and distribution of goods and services.

Company chop. An official company seal or signature stamp used to verify company documents, contracts, and often financial transactions.

Comparative advertising. The comparing of similar products for the purpose of persuading customers to buy a particular one.

Competition Act. A Canadian federal law that regulates anti- competitive practices and prohibits actions that will substantially lessen or prevent competition; it is similar to US antitrust laws.

Competitive intelligence. The gathering of external information on competitors and the competitive environment as part of the decision-making process.

Competitive scope. The breadth of a firm's target market within an industry.

Compound duty. A tariff consisting of both a specific and an ad valorem duty.

Concurrent engineering. The process of having design, engineering, and manufacturing people working together to create a product, in contrast to working in a sequential manner.

Consolidation. The translation of foreign affiliate accounts and addition to home-country accounts for the purpose of reporting the complete (global) condition of a company; consolidation of foreign affiliate accounts that are denominated in other currencies necessarily produces translation risk.

Container ships. Vessels used to carry standardised containers that can be simply loaded onto a carrier and then unloaded at their destination without any repackaging of the contents of the containers.

Contract management. A process by which an organisation (such as the government) transfers operating responsibility of an industry without transferring the legal title and ownership.

Control. The fundamental function of management that involves developing profit plans for the firm and its divisions and then deciding what to do when actual operating results differ from those planned.

Controlling. The process of determining that everything goes according to plan.

Coordinated infrastructure. An infrastructure used when there is a high degree of similarity among national markets and business units share resources in an effort to help each other raise overall sales.

Co-prosperity pyramid. A supply chain linked to a vertical, manufacturing *keiretsu*. It is hierarchical, with firms in the top tiers engaged in technology sharing, personnel exchanges, cross-shareholding, and long-term trading relationships. The further down the hierarchy a firm sits, the more important price becomes and the less such firms are considered *keiretsu* members.

Corporate culture. The shared values, traditions, customs, philosophy, and policies of a corporation; also, the professional atmosphere that grows from this and affects behaviour and performance.

Corporate Social Responsibility (CSR). Managing the business to ensure that it has an overall positive impact on society and the environment. Putting stakeholders first, rather than shareholders.

Corruption. The misuse of public power for private benefit.

Cost-of-living allowance. A payment to compensate for differences in expenditures between the home country and the foreign location.

Cost strategy. A strategy that relies on low price and is achieved through approaches such as vigorous pursuit of cost reductions and overhead control, avoidance of marginal customer accounts, and cost minimisation in areas such as sales and advertising.

Council of Ministers. The major policy decision-making body of the EU and one of its major institutions, consisting of one minister from each of the member states.

Council of the European Union. The major policy decision-making body of the EU; it consists of one minister from each of the 28 member states and is one of four major institutions of the EU.

Countertrade. Barter trade in which the exporting firm receives payment in products from the importing country.

Countervailing duty (CVD). Import tariff intended to protect domestic producers from harmful subsidisation by foreign governments.

Country risk analysis. Examines the chances of non-market events (political, social and economic) causing financial, strategic or personnel losses to a firm following FDI in a specific country market.

Court of Auditors A court that has one judge appointed from each EU member country; this court monitors the financial aspects of the union.

Court of Justice. A court that has one judge appointed from each EU member country; this court serves as the official interpreter of EU law.

Cultural assimilator. A programmed learning technique designed to expose members of one culture to some of the basic concepts, attitudes, role perceptions, customs, and values of another culture.

Cultural convergence. The growing similarity between national cultures, including the beliefs, values, aspirations and the preferences of consumers, partly driven by global brands, media and common global icons.

Culture. The sum total of the beliefs, rules, techniques, institutions and artefacts that characterise human populations or the collective programming of the mind.

Culture clash. When two cultural groups (national or corporate) meet, interact or work together and differences in their values, beliefs, rules of behaviour or styles of communication create misunderstandings, antagonism, or other problems.

Currency diversification. An exchange risk management technique through which the firm places activities or assets and liabilities into multiple currencies, thus reducing the impact of exchange rate change for any one of them.

Currency inconvertibility. The inability of a firm to transfer profit from a subsidiary in a host country to other areas of the organisation or to shareholders because of host-government restrictions on profit remittances.

Currency option. A derivative financial instrument where the owner has the right but not the obligation to exchange money denominated in one currency into another currency at a pre-agreed exchange rate on a specified date. The right to buy is the call option and the right to sell is the put option. It allows the company to take advantage of favourable movements in exchange rates. Options are the only form of hedging that does this.

Current account. A BOP category that consists of merchandise trade, services and gifts (unilateral transfers).

Customs union. A form of economic integration in which all tariffs between member countries are eliminated and a common trade policy towards non-member countries is established.

Debt–equity ratio. The value of a firm’s total debt divided by the value of its total equity; a higher ratio implies greater leverage and potentially greater risk.

Decision making. The process of choosing from among alternatives.

Delayed differentiation. A strategy in which all products are manufactured in the same way for all countries or regions as late as possible in the assembly process, at which time differentiation is used to introduce particular features or special components.

Demand conditions. The size, composition and changes in domestic market demand which firms respond to as they develop products and services for customers. These factors shape the innovation-related capabilities of firms.

Demand-Flow™ Technology (DFT). A production process that is flexible to demand changes.

Democracy. A system of government in which the people, either directly or through their elected officials, decide what is to be done.

Diamond model. A framework to examine and compare the main factors which characterise the national competitive environment of firms and shape their competitive strengths and weaknesses compared to firms from other countries.

Differentiation strategy. A strategy directed toward creating something that is perceived as being unique.

Diffuse. A tendency for workplace relationships and obligations, including relative status and hierarchical position, to extend into social situations and activities outside of work.

Distribution. The course that goods take between production and the final consumer.

Divestiture. (Also see *Privatisation*.) A process by which a government or business sells assets.

Double Diamond. An extension of the Diamond Model, with the addition of a second country as the location of any one or more of the components of

the competitive environment which influences the firm (factor conditions, demand conditions, related and supporting industries, etc.)

Dumping. The selling of imported goods at a price below cost or below that in the home country.

Dynamic capability. The firm's ability to integrate, build, and reconfigure internal and external competences to address rapidly changing environments.

Economic globalisation. The growing interdependence of locations and economic actors across countries and regions.

Economic integration. The establishment of transnational rules and regulations that enhance economic trade and cooperation among countries.

Economic risk. The risk of financial loss or gain to an MNE due to the effects of unanticipated exchange rate changes on future cash flows that are denominated in foreign currencies.

Economic union. A form of economic integration characterised by free movement of goods, services, and factors of production among member countries and full integration of economic policies.

Embargo. A quota set at zero, thus preventing the importation of those products that are involved.

Emotional. An acceptance of emotion and subjectivity as the bases for some decision making and a preference for explicit displays of emotions and feelings in the workplace.

Empowerment. The process of giving employees increased control over their work.

***Endaka*.** Yen appreciation; the growing value of the yen vis-à-vis other currencies which, among other things, made Japan a relatively expensive place to manufacture.

Enterprise for the Americas. An idea launched by President George Bush to create a free trade area from Alaska to Argentine Antarctica.

Esprit de corps. The spirit of a group that makes the members want the group to succeed.

Estimation by analogy. A method of forecasting market demand or market growth based on information generated in other countries, such as determining the number of refrigerators sold in the United States as a percentage of new housing starts and using this statistic in planning for the manufacture of these products in other world markets.

Ethnocentric predisposition. The tendency of a manager or multinational company to rely on the values and interests of the parent company in formulating and implementing the strategic plan.

Ethnocentric solution. A centralised decision-making framework in which financial decisions and control for foreign affiliates are largely integrated into home-office management.

Ethnocentrism. A belief in the superiority of one's own ethnic group; the dominance of the home-country culture in decision making, human resource management, and overall corporate culture in a multinational firm.

Eurobond. A bond denominated in foreign currency issued in any country's financial market; most eurobonds are issued in London or in Luxembourg (for tax reasons).

Eurocurrency. A bank deposit in any country that is denominated in a foreign currency. A yen-denominated bank deposit in Germany is a euro–yen deposit, a form of euro-currency.

Eurodollar. A dollar-denominated bank deposit outside the United States.

European Coal and Steel Community (ECSC). A community formed in 1952 by Belgium, France, Italy, Luxembourg, the Netherlands and West Germany

for the purpose of creating a common market that would revitalise the efficiency and competitiveness of the coal and steel industries in those countries.

European Commission. A 28-member group chosen by agreement of member governments of the EU; the Commission is the executive branch of the EU.

European Council. Composed of the heads of state of each EU member country as well as the president of the European Commission. Meetings of the Council take place at least twice a year and their purpose is to resolve major policy issues and to set policy direction.

European Free Trade Association (EFTA). A free trade area currently consisting of Iceland, Liechtenstein, Norway, and Switzerland; past members included the UK (before it joined the EU).

European Monetary Union (EMU). The agreement among, initially, 11 of the European Union countries to eliminate their currencies and create the euro; European Union countries do not necessarily have to join the EMU.

European Parliament. A group of 750 representatives elected directly by voters in each member country of the EU plus the EU President; the Parliament serves as a watchdog on EU expenditures.

European Research Cooperation Agency. A research and development alliance that emphasises projects in the fields of energy, medicine, biotechnology, communications, information technology, transport, new materials, robotics, production automation, lasers and the environment.

European Union (EU). A treaty-based institutional framework that manages economic and political cooperation among its 28 member states: Austria, Belgium, Bulgaria, Croatia, Cyprus, the Czech Republic, Denmark, Estonia, France, Finland, Germany, Greece, Hungary, Ireland, Italy,

Latvia, Lithuania, Luxembourg, Malta, the Netherlands, Poland, Portugal, Romania, Slovakia, Slovenia, Spain, Sweden and the UK.

Exchange controls. Controls that restrict the flow of currency.

Exchange rate. The value of one currency in terms of another; for example, US $1.2378/€1.

Exchange risk. The risk of financial loss or gain due to an unexpected change in a currency's value.

Exchange risk adaptation. An exchange risk management technique through which a company adjusts its business activities to try to balance foreign currency assets and liabilities, and inflows and outflows.

Exchange risk avoidance. An exchange risk management technique through which the firm tries to avoid operating in more than one currency.

Exchange risk transfer. An exchange risk management technique through which the firm contracts with a third party to pass exchange risk on to that party, via such instruments as forward contracts, futures and options.

Expatriates. Individuals who reside abroad but are citizens of the multinational's parent country; they are citizens of the home, not the host, country.

Export tariff. A tax levied on goods sent out of a country.

Exports. Goods and services produced by a firm in one country and then sent to another country.

Expropriation. The governmental seizure of private businesses coupled with little, if any, compensation to their owners.

External economies of scale. Efficiencies brought about by access to cheaper capital, highly skilled labour and superior technology.

Factor conditions. The national characteristics, including physical resources, infrastructure, labour skills, finance and knowledge which influence the

competitive strengths and weaknesses of firms that evolve in a particular country.

Factor endowment theory. A trade theory which holds that nations will produce and export products that use large amounts of production factors that they have in abundance and will import products requiring a large amount of production factors that they lack.

Flying Geese model. A model suggesting that Asian countries are following Japan's historical economic transition, specialising in particular industries (steel to textiles to clothing to autos to electronics) during particular growth stages. At a particular point in time we should expect to see these industries located in different Asian countries, depending on their resource endowments, labour costs and capabilities.

Focus strategy. A strategy that concentrates on a particular buyer group and segments that niche based on product line or geographic market.

Foreign bond. A bond issued by a foreign company in another country's financial market.

Foreign direct investment (FDI). Equity funds invested in other nations. It is different from portfolio (financial) investment in that FDI is undertaken by MNEs which exercise control of their foreign affiliates.

Foreign exchange. Foreign currency-denominated financial instruments, ranging from cash to bank deposits to other financial contracts payable or receivable in foreign currency.

Foreign exchange brokers. A company that provides specialised services to commercial banks in the interbank foreign exchange market, essentially functioning to unite interested buyers and sellers of foreign currency-denominated bank deposits; brokers intermediate about half of all wholesale foreign exchange transactions in New York and London.

Foreign exchange traders. Bankers who deal in foreign exchange, buying and selling foreign currencies on behalf of clients and/or for the bank itself; typically they deal in foreign currency-denominated bank deposits.

Foreign investment controls. Limits on foreign direct investment or the transfer or remittance of funds.

Foreign investment review agency. A government agency that reviews applications for foreign direct investment projects and approves or disapproves the projects, according to standards established by the government.

Foreign Sales Corporation Act. Legislation designed to allow US exporters to establish overseas affiliates and not pay taxes on the affiliates' income until the earnings are remitted to the parent company.

Foreign trade zones. Areas where foreign goods may be held and processed and then re-exported without incurring customs duties (same as a free trade zone).

Formal institutions. Rules that may be in the form of legal code, laws and promulgations, government decrees that are legally laid out and codified.

Forward integration. The purchase of assets or facilities that move the company closer to the customer, such as a computer manufacturer that acquires a retail chain that specialises in computer products.

Forward rate. An exchange rate contracted today for some future date of actual currency exchange; banks offer forward rates to clients to buy or sell foreign currency in the future, guaranteeing the rate at the time of the agreement.

Free trade area. An economic integration arrangement in which barriers to trade (such as tariffs) among member countries are removed.

Free Trade Area of the Americas (FTAA). A regional trade agreement that is expected to succeed NAFTA and includes 34 countries across North, Central and South America.

Free trade zone. A designated area where importers can defer payment of customs duty while further processing of products takes place (same as a foreign trade zone).

Fronting loan. A third-party loan in which an MNE home office deposits funds with a financial institution, which then lends to the MNE's affiliate in a country where the MNE faces political risk or currency transfer restrictions.

Funds positioning techniques. Mechanisms such as transfer pricing, intercompany loans, and timing of payments that are used to move funds from one affiliate to another in a multinational firm.

***Gaijin*.** A term used for non-Japanese; while not too offensive it is not particularly polite; *gai* means outside or foreign, *jin* means person.

General Agreement on Tariffs and Trade (GATT). A major trade agreement that was established to negotiate trade concessions among member countries, and since superseded by the WTO agreements.

Geocentric predisposition. The tendency of a multinational to construct its strategic plan with a global view of operations.

Geocentric solution. A decision-making framework in which financial decisions and evaluation related to foreign affiliates are integrated for the firm on a global basis.

Geocentrism. Neither home- nor host-country culture dominates decision making, human resource management and overall corporate culture in a multinational firm.

Gestion. The skill or practice of controlling, directing, or planning something, especially a commercial enterprise or activity.

Global area structure. An organisational arrangement in which primary operational responsibility is delegated to area managers, each of whom is responsible for a specific geographic region.

Global functional structure. An organisational arrangement in which all areas of activity are built around the basic tasks of the enterprise.

Global product structure. An organisational arrangement in which domestic divisions are given worldwide responsibility for product groups.

Global sourcing. The use of suppliers anywhere in the world, chosen on the basis of their efficiency.

Global value chain. Value chains are defined as the full range of activities bringing products or services from conception to production to consumption. Such chains that involve intra-firm or inter-firm economic activities beyond national borders are referred to as global value chains (GVCs).

Global production networks. Global production networks (GPNs) are organisational platforms where various actors from globally dispersed locations compete and cooperate for value creation, transformation and capture.

Global value chains. Stages of the production process are organised across multiple countries, so that firms can fully capture the cost (and other) advantages brought by a globalised world.

Globalisation. The production and distribution of products and services of a homogeneous type and quality on a worldwide basis.

Going Global. A key strategy of the Chinese government as part of the 11th Five-Year Plan, to internationalise target industry sectors and companies.

Grande école. One of the 'grand' or great schools considered to be the pinnacle of French higher education, highly selective and prestigious and the main source of the country's business and political leaders.

Gross value added (GVA) per head. GVA per head/employee is a common measure of labour productivity used to compare firms or countries.

***Guanxi*.** Denotes personalised or informal networks of relationships in China. They can be important preconditions for smoothing the way or gaining favours or advantages, particularly when both society and the economy are dominated by central government. There are parallels with the concept of social capital.

***Hai*.** 'Yes' in Japanese does not necessarily mean 'yes I agree', but 'yes, I hear what you say'.

Hardship allowance. A special payment made to individuals posted to geographic areas regarded as less desirable.

Heckscher–Ohlin theory. A trade theory that extends the concept of comparative advantage by bringing into consideration the endowment and cost of factors of production and helps to explain why nations with relatively large labour forces will concentrate on producing labour-intensive goods, whereas countries with relatively more capital than labour will specialise in capital-intensive goods.

Hedge. A strategy to protect the firm against risk, in this case against exchange rate risk.

Home-country nationals. Citizens of the country where the multinational resides.

Horizontal integration. The purchase of firms in the same line of business, such as a computer chip firm that acquires a competitor.

Host-country nationals. Local people hired by a multinational.

Humane orientation. Cultures that emphasise helping others, charity and people's wider social obligations.

Ideology. A set of integrated beliefs, theories and doctrines that helps to direct the actions of a society.

Import tariff. A tax levied on goods shipped into a country.

Imports. Goods and services produced in one country and bought in by another country.

Indigenisation laws. Laws which require that nationals hold a majority interest in all enterprises.

Individualism. The tendency of people to look after themselves and their immediate family only.

Industrial democracy. The legally mandated right of employees to participate in significant management decisions.

Informal institutions. Rules that are not always laid out in the form of written instruction, but come out of usage and tradition, and are often unwritten and tacit.

Initial screening. The process of determining the basic need and potential of the multinational's goods and services in foreign markets.

Innovation. The renewal and enlargement of the range of products and services and the associated markets; the establishment of new methods of production, supply, and distribution; the introduction of changes in management, work organisation, and the working conditions and skills of the workforce.

Institutions. The sets of common habits, routines, established practices, rules or laws that regulate the interaction between individuals and groups.

Integrative techniques. Strategies designed to help a multi-national become a part of the host country's infrastructure.

Interdependence. Mutual reliance between groups of actors; individuals, firms, countries, or regions.

Intermodal containers. Large metal boxes that fit on trucks, railroad trains, and aircraft and help reduce handling costs and theft losses by placing the merchandise in a tightly sealed, easy-to-move unit.

Internal economies of scale. Efficiencies brought about by lower production costs and other savings within a firm.

International business. The study of transactions taking place across national borders for the purpose of satisfying the needs of individuals and organisations.

International division structure. An organisational arrangement in which all international operations are centralised in one division.

International Fisher effect. The theory of exchange rate determination that states that differences in nominal interest rates on similar-risk deposits will be eliminated by exchange rate changes.

International human resource management (IHRM). The process of selecting, training, developing and compensating personnel in overseas positions.

International joint venture (IJV). An agreement between two or more partners to own and control an overseas business.

International logistics. The designing and managing of a system to control the flow of materials and products throughout the organisation.

International market assessment. An evaluation of the goods and services that the multinational can sell in the global marketplace.

International marketing. The process of identifying the goods and services that customers outside the home country want and then providing them at the right price and place.

International Monetary Fund (IMF). The international organisation founded at Bretton Woods, New Hampshire, in 1944 that includes most countries of the world and offers balance of payments support to countries in crisis along with financial advice to central banks.

International monetary system. The arrangement between national governments/central banks that oversees the operation of official foreign exchange dealings between countries.

International product life cycle (IPLC) theory. A theory of the stages of production of a product with new 'know-how': it is first produced by the parent firm,

then by its foreign subsidiaries, and finally anywhere in the world where costs are the lowest; it helps explain why a product that begins as a nation's export often ends up as an import.

International screening criteria. Factors used to identify individuals regarded as most suitable for overseas assignments.

International trade. The exchange of goods and services across international borders.

Intra-regional investments. Investments in the local region rather than in other triad or non-triad regions, such as when Chinese firms invest in other Southeast Asian economies.

Investment Canada Act (ICA). A law enacted to significantly reduce restrictions for foreign investors in Canada to create a more open economy.

Just-in-time inventory (JIT). The delivery of parts and supplies just as they are needed.

***Kaizen*.** Normally taken to mean 'continuous improvement' and associated with lean or low-cost, high-productivity manufacturing. A more accurate interpretation is 'to dismantle and reassemble a process to make it better'. As such *kaizen* was an early form of business process re-engineering.

***Keiretsu*.** Groupings of Japanese firms with long-term associations and cross-shareholdings; each firm maintains its operational independence but coordinates strategy and often exchanges assets and resources with other firms in its group.

Kinesics. A form of non-verbal communication that deals with conveying information through the use of body movement and facial expression.

***Kinyu*.** Horizontal conglomerates encompassing a wide range of diversified businesses, centred on a dominant bank and/or trading company.

Korean *chaebols*. Traditionally family-dominated, diversified conglomerates. Family ownership has been reduced and many are now focused in

particular business sectors, reducing their diversity. There are parallels with Japanese *sogo shosha* in terms of early government support and their relationship with dominant national banks.

KTI industries. They include: 1 Knowledge-intensive service industries (e.g., financial services) 2 High-technology manufacturing (e.g., pharmaceuticals) 3 Medium-high-technology manufacturing industries (e.g., motor vehicles)

Latin American Integration Association (LAIA). A free trade group formed to reduce intra-regional trade barriers and to promote regional economic cooperation; Argentina, Bolivia, Brazil, Chile, Colombia, Ecuador, Mexico, Paraguay, Peru, Uruguay and Venezuela are all members.

Leontief paradox. A finding by Wassily Leontief, a Nobel Prize-winning economist, which shows that the United States, surprisingly, exports relatively more labour-intensive goods and imports capital-intensive goods.

Liberalisation policies. Government policies that move away from planned economies towards more free market systems; they are marked by the privatisation of state-owned businesses, a lowering of tariff and non-tariff barriers, and reductions in the constraints placed on foreign firms' investments and business activities.

Lighter aboard ship (LASH) vessels. Barges stored on a ship and lowered at the point of destination.

Localisation of production. The manufacturing of goods in the host market.

Localisation of profits. The reinvestment of earnings in the local market.

London interbank offered rate (LIBOR). The interest rate on large-scale foreign currency-denominated deposits offered from one bank to another in London.

Macro political risk. A risk that affects all foreign enterprises in the same way.

Make or buy decisions. The strategic decision to produce part of a product or service in-house, within the firm, or contract this out to other firms in the market and buy-in this part.

Managerial development. The process by which managers obtain the necessary skills, experiences and attitudes that they need to become or remain successful leaders.

Maquiladora industry. Named after the practice of millers charging a *maquila*, or 'miller's portion', for processing other people's grain, this is a free trade zone that has sprung up along the US–Mexican border for the purpose of producing goods and then shipping them between the two countries.

Market coordination infrastructure. An infrastructure used by firms that compete in similar national markets but do little resource sharing among their businesses.

Market-driven economy. An economy in which goods and services are allocated on the basis of consumer demand.

Market growth. The annual increase in sales in a particular market.

Market indicators. Indicators used for measuring the relative market strengths of various geographic areas.

Market intensity. The richness of a market or the degree of purchasing power in one country as compared to others.

Market-seeking FDI. MNEs invest in distribution, sales or marketing operations in order to sell products or services (outputs) in particular country markets.

Market size. An economic screening consideration used in international marketing; it is the relative size of each market as a percentage of the total world market.

Masculinity. The degree to which the dominant values of a society are success, money and material things.

Material handling. The careful planning of when, where and how much inventory will be available to ensure maximum production efficiency.

Matrix structure. An organisational arrangement that blends two organisational responsibilities such as functional and product structures or regional and product structures.

Mental maps. Cognitive representations of the nature and attributes of the spatial environment, showing how 'psychic distance' operates in practice for SME managers.

Mercantilism. A trade theory which holds that a government can improve the economic well-being of the country by encouraging exports and stifling imports to accumulate wealth in the form of precious metals.

Mercosur. A sub-regional free trade group formed to promote economic cooperation; the group consists of Argentina, Brazil, Paraguay and Uruguay.

Meta-integrator. The modern MNE is a meta-integrator, in that it must be able to leverage knowledge within its complex structure and across its external affiliations. This requires efficient internal markets and well-structured cross-border hierarchies.

Micro political risk. A risk that affects selected sectors of the economy or specific foreign businesses.

Ministry of Economy, Trade and Industry (METI). A Japanese ministry charged with providing information about foreign markets and with encouraging investment in select industries and, in the process, helping to direct the economy. From the post-war period to 2001 it was known as the Ministry of International Trade and Industry (MITI).

Ministry of Finance (MOF). Works alongside METI and is similarly influential vis-à-vis regulation and restructuring of Japan's capital markets.

Mitsubishi *Kinyokai*. The Friday Club in Marunouchi, Tokyo, where the most senior managers from the 29 core firms of the Mitsubishi *keiretsu* gather each month to discuss business.

***Mittelstand*.** About 3.4 million small and medium-sized firms defined as having less than €50 million turnover that make up the heart of the German economy.

Mixed economies. Economic systems characterised by a combination of market- and centrally driven planning.

Mixed structure. A hybrid organisation design that combines structural arrangements in a way that best meets the needs of the enterprise.

Modular integrated robotised system (MIRB). A software-based production process that relies entirely on robots.

Modular manufacturing. A manufacturing process that consists of modules that can be easily adapted to fit changing demand.

Monetary exchange rate. The price of one currency stated in terms of another currency.

Multilateral netting. Payment of net amounts due only between affiliates of an MNE that have multiple transactions among the group, which can be partially netted out among them, so then only the net funds need to be transferred.

Multinational enterprise (MNE). A multi-plant firm that controls and coordinates operations in at least two countries; or a firm that engages in value-added international business activities, that has affiliates in more than one country, and whose operations and activities in different locations are actively coordinated by one or more headquarters organisations.

National responsiveness. The ability of MNEs to understand different consumer tastes in segmented regional markets and to respond to different national

standards and regulations imposed by autonomous governments and agencies.

Nationalisation. A process by which the government takes control of business assets, sometimes with remuneration of the owners and other times without such remuneration.

***Nemawashi*.** Literally means 'root tying' and is a process of consultation to get agreement on a particular issue before it becomes explicit policy.

Neo-mercantilism. A trade theory which holds that a government can improve the economic well-being of the country by encouraging exports and stifling imports.

Neutral. A preference for unemotional, objective analysis of a situation or a decision and for limited displays of emotions and feelings in the workplace.

Newly industrialised countries (NICs). A subgroup of emerging market economies that have experienced rapid economic growth, normally accompanied by political and social change; the forerunners were the four Asian 'Tiger' economies: Singapore, South Korea, Taiwan and Hong Kong. The rapid growth, increased trade and FDI, and integration of China in the global economy show that it is approaching this status.

Nominal interest rate. The actual rate of interest offered by a bank, typically given as an annual percentage rate.

Non-governmental organisations (NGOs). Private sector groups that act to advance diverse social interests (see also *Civil society*).

Non-tariff barriers. Rules, regulations and bureaucratic red tape that delay or preclude the purchase of foreign goods.

North American Free Trade Agreement (NAFTA). A regional free trade agreement among Canada, the United States and Mexico.

Official reserves. Funds owned by national monetary authorities that are used for bringing BOP accounts into balance.

Open innovation. Interactive, collaborative networks of product or service providers and customers or users which help firms innovate more efficiently.

Particularism. Judging a situation and adjusting rules and procedures according to the specific situation or individuals involved.

Personal selling. A direct form of promotion used to persuade customers to a particular point of view.

PEST framework. Examines the political, economic, socio-cultural and technological conditions in particular country markets.

Plaza Accord. An agreement signed by the G5 in 1985 in New York, agreeing to devalue the US dollar against the Japanese yen and the deutsche (German) mark; it triggered the bubble economy and eventual economic recession in Japan in the 1990s.

Political risk. The probability that political forces will negatively affect a multinational's profit or impede the attainment of other critical business objectives.

Political union. An economic union in which there is full economic integration, unification of economic policies and a single government.

Polycentric predisposition. The tendency of a multinational to tailor its strategic plan to meet the needs of the local culture.

Polycentric solution. A decentralised decision-making framework in which financial decisions are largely allocated to foreign affiliates and financial evaluation of affiliates is done in comparison to other firms in that context.

Polycentrism. Each subsidiary, division, or function reflects the culture of its host country; local managers' cultural predispositions and decision

making dominate over those of home-country managers in a multinational firm.

Power distance. A cultural dimension that measures the degree to which less powerful members of organisations and institutions accept the fact that power is not distributed equally.

Privatisation. The process of selling government assets to private buyers.

Process mapping. A flowchart of every step that goes into producing a product.

Product managers. Managers responsible for coordinating the efforts of their people in such a way as to ensure the profitability of a particular business or product line.

Productivity. The main measure of efficiency, used at the national level as well as by firms to track how much output (goods, services) is created by a certain amount of inputs (capital, employees, investment etc.).

Production system. A group of related activities designed to create value.

Promotion. The process of stimulating demand for a company's goods and services.

Protective and defensive techniques. Strategies designed to discourage a host country from interfering in multinational operations.

Proxemics. A form of non-verbal communication that deals with how people use physical space to convey messages.

Psychic distance. A measure of the similarity or difference between two cultures; also commonly defined as the measurable distance between the home market and a foreign market resulting from the perception of cultural and business differences.

Purchasing power parity. The theory of exchange rate determination that states that differences in prices of the same goods between countries will be eliminated by exchange rate changes.

Quota. A quantity limit on imported goods.

Real interest rate. The nominal interest rate adjusted for price changes. Domestically, this means adjusting for inflation; internationally, this means adjusting for exchange rate (currency price) changes.

Regiocentric predisposition. The tendency of a multinational to use a strategy that addresses both local and regional needs.

Regional managers. In a geocentric matrix, managers charged with selling products in their geographic locale.

Regression analysis. A mathematical approach to forecasting that attempts to test the explanatory power of a set of independent variables.

Repatriation. The process of returning home at the end of an overseas assignment.

Repatriation agreement. An agreement that spells out how long a person will be posted overseas and sets forth the type of job that will be given to the person upon returning.

Resource managers. In a matrix structure, managers charged with providing people for operations.

Resource-seeking FDI. MNEs invest in production-related activities to benefit from cheaper or better sources of inputs in a particular location; these can include raw materials, components or labour and expertise.

Resource-sharing infrastructure. An infrastructure used by firms that compete in dissimilar national markets but share resources such as R&D efforts and manufacturing information.

Return on investment (ROI). A percentage determined by dividing net income before taxes by total assets.

Ringi**.** The formalised consensus process of decision making; the *ringisho* is a decision proposal circulated around company departments to be revised or approved before implementation.

Roll-on-roll-off (RORO) vessels. Ocean-going ferries that can carry wheeled cargo such as automobiles, trailers and trucks that drive onto built-in ramps and roll off at the point of debarkation.

Secular totalitarianism. A system of government in which the military controls everything and makes decisions that it deems to be in the best interests of the country.

Sequential. Cultures that view time in a sequential or linear fashion; order comes from separating activities and commitments.

Single European Act (SEA). An Act passed by the EU that contains many measures to further integrate the member states, along economic and political dimensions, and that allows the Council of Ministers to pass most proposals by a majority vote, in contrast to the unanimous vote that was needed previously.

Single European Market (SEM). A market consisting of all members of the EU, bound together by a single currency, a special charter, complete harmonisation of social and economic policies and a common defence policy.

Small and medium-sized enterprises (SMEs). Defined by governments using different criteria for policy purposes. SMEs are firms with fewer than 250 employees in Europe, but fewer than 500 in the United States. Indian manufacturing firms qualify as SMEs if they invest less than US$2 million in plant and equipment.

Social media influencer. An active online personality whose expertise, style, personality or celebrity fame induces large groups of followers to buy products and services they promote.

Socialisation. The process of enculturation, or the adoption of the behaviour patterns of the surrounding culture.

Sogo shosha**.** International trading companies that help other Japanese firms import and export products and services; they were very influential in the rapid growth era in helping local firms break into overseas markets.

Special drawing right (SDR). The currency of the IMF; accounts at the IMF are denominated in SDRs, and the IMF has issued about $204 billion of SDRs as currency since its inception in 1969.

Specific. A tendency to limit workplace relationships and obligations, including relative status and hierarchical position, to the workplace.

Specific duty. A tariff based on the number of items being shipped into a country.

Speculator. A person or firm that takes a position in foreign exchange with no hedging or protection mechanism to try to gain from expected exchange rate changes.

Spot rate. The exchange rate offered on the same day as the request to buy or sell foreign currency; actual settlement (payment) may occur one or two days later.

Standardised training programmes. Generic programmes that can be used with managers anywhere in the world.

State-owned enterprises (SOEs). Companies that are owned, financed and controlled by government.

Strategic alliance. A business relationship in which two or more companies work together to achieve a collective advantage.

Strategic business units (SBUs). Operating units with their own strategic space; they produce and sell goods and services to a market segment and have a well-defined set of competitors.

Strategic cluster. A network of businesses and supporting activities located in a specific region, where flagship firms compete globally and supporting activities are home based.

Strategic planning. The process of evaluating the enterprise's environment and its internal strengths and then identifying long- and short-range activities.

Strategy formulation. The process of evaluating the enterprise's environment and its internal strengths.

Strategy implementation. The process of attaining goals by using the organisational structure to execute the formulated strategy properly.

Synchronic. Cultures that view events in parallel over time; order comes from coordinating multiple activities and commitments.

Systems of innovation (SI). These stress the 'importance of 'systemic' interactions between the various components of inventions, research, technical change, learning and innovation. The national systems of innovation (NSI) bring to the forefront the central role of the state as a coordinating agent' (Soete et al., *Systems of Innovation*, 2010).

Tailor-made training programmes. Programmes designed to meet the specific needs of the participants, typically including a large amount of culturally based input.

Tariff. A tax on goods shipped internationally.

Tax havens. Jurisdictions that offer the MNE a lower tax rate (or no tax) than in other places, so that MNEs can locate some of their business activities there and thus reduce overall tax payments.

Theocratic totalitarianism. A system of government in which a religious group exercises total power and represses or persecutes non-orthodox factions.

Theory of absolute advantage. A trade theory which holds that nations can increase their economic well-being by specialising in goods that they can produce more efficiently than anyone else.

Theory of comparative advantage. A trade theory which holds that nations should produce those goods for which they have the greatest relative advantage.

Third-country nationals. Citizens of countries other than the one in which the multinational is headquartered or the one in which they are assigned to work by the multinational.

Time-to-market accelerators. Factors that help reduce bottlenecks and errors and ensure product quality and performance.

Total factor productivity (TFP). TFP measures the proportion of output not explained by the amount of inputs used in production and indicates how efficiently the same, given set of inputs are used in different production processes.

Totalitarianism. A system of government in which one individual or party maintains complete control and either refuses to recognise other parties or suppresses them.

Trade adjustment assistance. Assistance offered by the US government to US businesses and individuals harmed by competition from imports.

Trade creation. A process in which members of an economic integration group begin to focus their efforts on those goods and services for which they have a comparative advantage and start trading more extensively with each other.

Trade diversion. Occurs when members of an economic integration group decrease their trade with non-member countries in favour of trade with each other.

Training. The process of altering employee behaviour and attitudes in a way that increases the probability of goal attainment.

Transaction risk. The risk of financial loss or gain to an MNE due to unanticipated exchange rate changes affecting future cash flows from transactions that are denominated in foreign exchange.

Transfer price. The price used for an intracompany payment for shipment of products or services from one affiliate to another in an MNE; these prices

can be used to reduce taxes, move funds to desired locations, and so on.

Transit tariff. A tax levied on goods passing through a country.

Transition strategies. Strategies designed to help smooth the move from foreign to domestic assignments.

Translation risk. The risk of losses or gains on the MNE's balance sheet, due to unhedged exchange rate changes during an accounting period.

Transnational network structure. An organisation design that helps MNEs take advantage of global economies of scale while also being responsive to local customer demands.

Transparency. The *clarity* and *consistency* of policies and legislation applied in the governance of businesses.

Trend analysis. The estimation of future demand by either extrapolating the growth over the last three to five years and assuming that this trend will continue or by using some form of average growth rate over the recent past.

Uncertainty avoidance. The extent to which people feel threatened by ambiguous situations and have created institutions and beliefs for minimising or avoiding those uncertainties.

Unconventional cargo vessels. Vessels used for shipping oversized and unusual cargoes.

United States–Canada Free Trade Agreement (FTA). A trade agreement that eliminates most trade restrictions (such as tariffs) between these two countries and extends national treatment to foreign investment.

Universalism. The uniform application of rules and procedures, regardless of situation, context or individuals involved.

Upstream and downstream. Common terms in production process industries, such as oil and gas, metals, and bio- pharmaceuticals. They represent the beginning and end stages of the production process. Upstream production

is the process of exploring and extracting raw materials, whereas the downstream stage involves processing the materials into a finished product and selling it.

Value chain. The way in which primary and support activities are combined in providing goods and services and increasing profit margins.

Vertical integration. The ownership of assets involved in producing a good or service and delivering it to the final customer.

Virtual integration. A networking strategy based on cooperation within and across company boundaries.

Weighted-average cost of capital (WACC). The firm's cost of obtaining funds from the various sources avail able. Each source of funds is weighted (multiplied) by the percentage of total capital it provides. Thus, the WACC is W_1 (cost of using retained earnings) + W_2 (cost of bank borrowing) + W_3 (cost of other source of funds), where each cost is stated as an annual percentage rate and each W is the percentage of total capital from that source.

Weighted Country Risk Assessment Model. Combines an investment project appraisal with country risk analysis.

Wholly foreign-owned enterprise (WFOE). A wholly foreign-owned enterprise is a limited liability company under Chinese company law and the preferred mode of investment for foreign MNEs looking to manufacture in China. WFOEs are also known as WOFEs (wholly owned foreign enterprises).

Work councils. Groups that consist of both worker and manager representatives and are charged with dealing with matters such as improving company performance, working conditions and job security.

Working capital. Short-term financial instruments such as bank deposits and marketable securities that can be optimised by the MNE on a global basis.

World Bank. The world's largest development bank, formed along with the IMF at Bretton Woods in 1944. Its original name was the International Bank for Reconstruction and Development (IBRD). The World Bank assists developing countries with loans and economic advising for economic development.

World Trade Organization (WTO). An international organisation that deals with the rules of trade among member countries; one of its most important functions is to act as a dispute-settlement mechanism.

WTO accession. Admission to the World Trade Organization; in return for the right to access and to engage in fair trade with other national markets, the country must liberalise its own markets.

***Zaibatsu*.** The pre-war antecedents of some modern-day *keiretsu* in Japan; attempts by the allied forces to break these up after World War II largely failed.

INDEX

<u>Note</u>: Page numbers in **bold** indicate Glossary entries

Chapter 1
An Introduction to International Business

Objectives of the chapter

Introduction

What is international business?

Globalisation

- The outcomes of globalisation
- Understanding interdependence in globalisation
- Regional integration
- Mapping globalisation

Technology and innovation

- New technologies
- The knowledge-intensive, multi-technology firm

Socio-political developments

What are institutions?

- Institutions and supranational agreements
- Globalisation and liberalisation

Multinational enterprises

- Proto-globalisation and the MNE in historical context
- The industrial revolutions and the growth of private firms

Foreign direct investment

- Measuring FDI and MNE activity
- MNEs before World War II
- The rise of the modern MNE

International business in the modern era

- 1950–90: the rise of the triad

Objectives of the chapter

Active Learning Case

GE Healthcare in India: locally driven innovation

Introduction

Trends in innovation at the country and firm level

The resource-based view (RBV) and the VRIO framework

Resources and capabilities

The VRIO framework

Dynamic capabilities

Quick learning/incremental learning

Integration of new assets/radical learning

Modification and transformation of new organisational assets

Dynamic capabilities and small firms

International Business Strategy in Action

Spreadshirt: open innovation

Innovation and location advantages

International dimensions of innovation

The location of innovation activities in the MNE

International Business Strategy in Action

Innovation networks at IBM

The innovative MNE as a differentiated network

Key points

Key terms

Real Cases

Canon Group

R&D at Hewlett-Packard

Part Two

THE ENVIRONMENT OF INTERNATIONAL BUSINESS

Chapter 4

International Politics

Chapter 5
International Culture

Chapter 6
International Trade

Chapter 7
International Financial Markets and Institutions

Part Three

International Business Strategies

Chapter 8

Multinational Strategy

Chapter 9
Organising Strategy

Chapter 10

Corporate Strategy and National Competitiveness

Chapter 12
Marketing Strategy

Chapter 13
Human Resource Management Strategy

Chapter 14
Political Risk and Negotiation Strategy

Chapter 15

International Financial Management

Part Five

Regional Strategies

Chapter 16
European Union

Chapter 17
Japan

Chapter 18
North America

Chapter 19
Emerging Economies

Chapter 20

China

Index